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DEPOSITORY INSTITUTIONS

Flexible Accounting Rules Lead to Inflated Financial Reports

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Comptroller General of the United States

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The Honorable Donald W. Riegle
Chairman
The Honorable Jake Garn
Ranking Minority Member
Committee on Banking, Housing
and Urban Affairs
United States Senate

The Honorable Henry B. Gonzalez
Chairman
The Honorable Chalmers P. Wylie
Ranking Minority Member
Committee on Banking, Finance
and Urban Affairs
House of Representatives

In our study of 39 banks which failed in 1988 and 1989,[1] we concluded that flexible accounting rules used to recognize and measure loan losses contributed to banks not accurately reporting these losses in their financial reports prior to failure. We recommended on April 22, 1991, that the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) revise accounting rules to require the prompt recognition of losses from problem (nonperforming) loans by applying known market conditions. We also recommended that the federal banking regulators promulgate accounting standards for depository institutions along the lines we recommended if the private sector standard setters did not act promptly.

The Congress recognized our concerns about bank financial reporting in enacting the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDIC Improvement Act). The act requires the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) to review accounting principles during 1992 and issue guidance to improve bank financial reporting by December 19, 1992.

[1] Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991).

This report (1) identifies the specific problems with present accounting rules for loan losses, including the November 1991 "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," issued by FDIC, FRB, OCC, and OTS, (2) describes the status of FASB projects related to these issues, and (3) makes recommendations for government action to set specific new accounting rules for losses from nonperforming bank loans. This report does not address comprehensive market value accounting, or the application of market value accounting concepts for performing loans. Although this report addresses accounting rules for individual nonperforming loans, it does not specifically address unallocated general reserves provided for groups of loans.

Although our recommendations are directed at depository institutions, the problems with the accounting rules for loan losses are likely to affect other industries with similar kinds of investments. The insurance industry, for example, appears to be particularly vulnerable at this time to the weaknesses of present accounting rules.

Results in Brief

Accounting rules applicable to problem loans are ambiguous and so flexible that, in practice, they are being misused to delay recognition of losses in financial reports. In the banking industry, the latitude given by the accounting rules has contributed to substantial losses not being reported to banking regulators. The use of undiscounted cash flow measures also allowed by the accounting rules hinders reporting loan losses and understates losses that are reported by not reflecting the time value of money. Further, the rules allow financial institutions to ignore the marketplace as a measure of value of problem loans and substitute optimistic values based on estimated improved future market conditions.

Recent federal bank regulatory guidance for valuing commercial real estate and related loans that suggests disregarding market prices and using future projections that reflect market recoveries is likely to exacerbate loan valuation problems.

The intended purpose of accounting rules is to provide a framework for fairly presenting an entity's financial condition and performance so that users have reliable data to make informed business decisions. The ambiguities we have noted in accounting rules and the federal regulators' recent guidance impede achievement of this objective.

FASB's project on accounting rules for impaired loans does not address all the problems we identified, and the proposed rules would not result in appropriate loss estimates. Although FASB proposed to discard the notion that undiscounted cash flows should be used to measure losses from problem loans, its techniques for developing estimates of such losses do not require consideration of market prices or market interest rates in either computing loss reserves or as a reality check on such reserves. Also, the ambiguous language in accounting rules for evaluating loans for possible losses is not changed.

In addition, even if it were revised to deal with the problems we have identified, FASB's project is not scheduled for completion until 1993 and will not be effective until calendar year 1994. Until accounting rules are strengthened and clarified, federal regulators may not recognize the extent of the problems in depository institutions until they become so severe that losses to the insurance funds cannot be prevented or minimized, and the early warning measures for identifying troubled institutions required by the FDIC Improvement Act will not work as intended.

Background

In our study of 39 banks which failed in 1988 and 1989, we concluded that the early warning system provided by bank financial reports is seriously flawed. Collectively, these 39 banks, selected judgmentally from the total 427 banks which failed in 1988 and 1989, accounted for more than 87 percent of total assets of all banks that failed nationwide during these 2 years. The 39 failed banks' financial reports did not warn the regulators about the true magnitude of deterioration in the banks' financial condition. As a result of asset valuations FDIC prepared after these banks failed, regulators increased these banks' loss reserves from $2.1 billion to $9.4 billion.

The accounting rules used to recognize and measure loan losses were a major factor in bank management not reporting the $7.3 billion deterioration in asset values on the financial reports. The deficiencies in accounting rules allowed bank management to unduly delay the recognition of losses and mask the need for early regulatory intervention that could have minimized losses to the Bank Insurance Fund.

In February 1991, FASB began a project to consider accounting rules for impaired loans. When a loan is not performing, creditors look to the collateral securing the loan to satisfy the debt. The loan impairment project is intended to resolve whether creditors should discount expected future

cash flows from the underlying collateral of a loan when determining the appropriate loss allowance for that loan.

On November 7, 1991, FDIC, FRB, OCC, and OTS issued an "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans." It provides regulatory guidance to examiners and management of depository institutions concerning valuation of real estate and related loan losses.

Objectives, Scope, and Methodology

Our objectives were to (1) provide a detailed analysis of the application of current accounting rules for loan loss recognition and measurement, (2) determine how FASB's current loan impairment project addressed our concerns over loan loss accounting rules, (3) analyze the November 7, 1991, interagency policy statement on reviewing commercial real estate loans and related guidance provided by the depository institution regulators to examiners and bank management, and (4) consider how our concerns could be addressed by the federal banking regulators pursuant to the FDIC Improvement Act.

To accomplish our objectives, we reviewed generally accepted accounting principles (GAAP), as well as selected regulatory releases and statements of the federal banking agencies, and analyzed relevant information relating to loan loss accounting. We met with FASB members and staff, the Financial Accounting Standards Advisory Council (a consultative body to FASB), and other interested parties to exchange views and obtain an understanding of FASB projects. We analyzed an initial draft of the standards section of the FASB's Exposure Draft "Accounting by Creditors for Impairment of a Loan," and monitored FASB deliberations to determine if our concerns were addressed by the proposed standard. We discussed our analysis with FASB and considered its views regarding our interpretation of the accounting literature in preparing this report. We obtained comments from FDIC, FRB, OCC, and OTS, which are provided in appendix II. Appendix I contains a detailed discussion of loan loss accounting rules, FASB's loan impairment project, and the interagency policy statement.

Loan Loss Reserves Have Not Reflected Economic Reality

Accounting rules are flawed in that they allow bank management considerable latitude in determining carrying amounts for problem loans and repossessed collateral. Recognizing decreases in the value of problem loans has an adverse effect on a bank's reported financial condition—specifically, the amount of a bank's capital. The level of a bank's capital is increasingly important in our regulatory system. For example, implementation of provisions of the FDIC Improvement Act of 1991 and regulations regarding bank access to brokered certificates of deposit funds use bank capital levels as a key determinant in regulatory actions. The FDIC's proposed risk-based premiums are also determined partially through reference to bank capital levels. This gives management of weak banks an incentive to use the latitude in accounting rules to delay loss recognition as long as possible, resulting in inaccurate financial reports that impede early warning of troubled banks and add to insurance losses.

Accounting rules are ambiguous because they require that losses be "probable" before they are recognized. "Probable" is too often being improperly interpreted as approaching "virtually certain." It is our view that a more appropriate approach to recognizing loan losses from the routine business of lending would be to require that losses be recognized when they are "more likely than not" (a more than 50 percent probability of loss). We believe that such a change would be a signal to bank management that evenhanded loss recognition is needed to improve bank financial reports.

Further, losses from bank loans are generally measured based on the difference between the carrying amount of the loan and the undiscounted future cash flows expected from the borrower. These measurements do not consider the time value of money, leading to loss reserves which do not reflect economic reality. As we stated in our 1991 Failed Banks report, we believe that the fair value concepts currently applicable in accounting for foreclosed assets (collateral securing a loan) also should be used in measuring losses from nonperforming loans.

However, fair value estimates developed under generally accepted accounting principles[2] do not always reflect economic reality because existing market conditions may not be appropriately considered. Accounting rules for determining when market prices are representative of

[2]Fair value is generally defined as the price that could be obtained in an arm's length transaction between willing parties in other than a forced or liquidation sale.

the value of impaired assets are not clear. In practice, the latitude given by the accounting rules can allow financial statement preparers to use estimates of future cash flows to derive fair value estimates while disregarding current market values. When estimates of cash flows are used, the lack of clarity regarding the length of time to be used in developing such estimates can allow financial statement preparers to make optimistic projections of economic improvements that may occur in the distant future.

The flexibility in the accounting rules regarding the use of market prices and what is a reasonable foreseeable future for a debtor to rebuild equity in the collateral supporting the loan or otherwise repay the loan can result in substantial differences in determining losses for a problem loan. As illustrated by a hypothetical example in appendix I, estimated losses associated with a $10 million troubled loan could range from zero to $5.8 million depending on whether market prices are used and the length of time considered reasonable to rebuild equity in the collateral; each estimate arguably complies with present generally accepted accounting principles.

When market prices are not used, we believe bank management should develop documentation to support its view that such prices do not reflect the value of impaired loans. In addition, when projections of cash flows are used, guidance is needed to limit the period of time considered in the valuation process to periods of time to fully lease the property. Such valuations should reflect existing market conditions. We note that some experts project that an over 10-year supply, at current absorption rates, exists for some types of property. Disregarding existing economic conditions and projecting an upturn in a hypothetical cycle is inappropriate and may not reflect economic reality.

Federal Regulatory Guidance May Exacerbate Weaknesses in Accounting Rules for Loan Losses

In their November 1991 "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans,"[3] the federal banking agencies provided guidance to examiners and management of depository institutions for developing loan loss reserves. The statement and related agency press releases may exacerbate weaknesses in accounting rules for loan losses, thereby encouraging institutions to develop value estimates and loss reserves by inappropriately (1) disregarding market prices in favor of using cash flow projections and (2) anticipating hypothetical

[3]See appendix I for a more detailed discussion of this guidance.

recoveries in markets. When combined with long time frames now acceptable to regulators in developing cash flow-based fair value projections and suggestions in the statement to consider the income producing capacity of the collateral over time in stabilized (normal) markets, this guidance is likely to result in inflated capital and regulatory leniency.

The impact of inappropriate loss reserves on bank capital positions is particularly troubling given the importance of capital positions in the recently enacted "tripwire" provisions of the FDIC Improvement Act. The effectiveness of these important provisions may be severely limited if recent regulatory guidance results in unreliable reporting of loan losses. Furthermore, the effectiveness of proposed open bank assistance methods, intended to reduce losses of insurance funds, may be critically flawed if capital positions reflect insufficient loan loss reserves. In such situations, regulators may inappropriately preserve shareholders' equity based on the improper assumption that the institution has capital when in fact it may be insolvent.

FASB's Impairment of a Loan Project As Currently Proposed Will Not Require Loss Estimates That Reflect Fair Value

FASB is currently finalizing a draft of a proposed accounting standard for impaired loans. This draft, which has not yet been released for public comment, reflects some progress in improving loan loss accounting, but fails to correct the major weaknesses that are leading to overstated asset values and capital. Under the standard, as currently proposed, a loan is potentially impaired when either it is probable that a creditor will be unable to collect all amounts due (principal and interest) according to the terms of the loan agreement or a loan's original contractual terms have been modified because of collectibility concerns. Minor shortfalls in the timing or amount of cash flows will not cause a loan to be identified as potentially impaired in the current FASB draft. Provided that in the final statement this exception for shortfalls is unambiguously defined to mean truly insignificant amounts, the nonperforming loans which are the focus of our concerns should meet the definition of impairment. In this case, the estimated future cash flows from the loan will then be discounted at the effective interest rate on the loan and the resultant present value amount compared with the loan's current carrying amount to determine if there is impairment to be recognized. We concur with FASB's decision to not allow undiscounted cash flows to be used to measure loan losses. However, as set forth below, the standard, as currently proposed, is not responsive to the primary concerns underlying our recommendations in the Failed Banks report.

Significant GAO recommendations not adopted by FASB are that (1) the "probable" criteria should be changed to a "more likely than not" criteria and (2) loss reserves should reflect the fair value of impaired loans and any related collateral, explicitly recognize transaction prices in active markets in developing such fair values, and require the use of market interest rates in discounting estimated cash flows. In addition, the proposed standard does not clarify the meaning of "foreseeable future" in developing cash flow projections nor address the use of current economic conditions in developing loss estimates.

We have discussed our concerns with FASB and suggested how the accounting rules currently being considered under the loan impairment project could be modified to address them. However, FASB's recent decision to measure loan impairment using effective interest rates suggests that fair value measurements will not be adopted. Further, it does not appear that FASB's project will be completed until 1993 and the need for improving financial reports for banks remains critical. The federal banking agencies have the ability to address our concerns in developing regulations to implement the FDIC Improvement Act.

Federal Banking Agencies Are Charged With Improving Bank Financial Reporting

The FDIC Improvement Act of December 19, 1991, establishes the following objectives for accounting principles applicable to reports filed with federal banking agencies:

"Accounting principles applicable to reports or statements required to be filed with Federal banking agencies by insured depository institutions should—

(A) result in financial statements and reports of condition that accurately reflect the capital of such institutions;

(B) facilitate effective supervision of the institutions; and

(C) facilitate prompt corrective action to resolve the institutions at the least cost to the insurance funds."

Before the end of the 1-year period after enactment of the FDIC Improvement Act, each federal banking agency is to review accounting principle requirements and procedures used in reports filed with a federal agency and modify or eliminate requirements that do not meet the above objectives. Further, the federal banking agencies are to develop and

prescribe regulations for bank financial reporting of off-balance sheet items and provide supplemental disclosure of the estimated fair market value of bank assets and liabilities. These other requirements are also very important. Off-balance sheet items may involve substantive risks to the banking system. Market values for bank assets and liabilities will provide useful evaluation information. FASB has recently issued a statement requiring some market value disclosures. However, the statement does not fully address underlying market value principles.

Conclusions

The FDIC Improvement Act provides essential reforms to improve federal oversight of banks and thrifts and to protect the insurance funds. Reliable financial data on the condition of the institutions is fundamental to the success of these reforms. Unfortunately, generally accepted accounting principles provide too much latitude in recognizing and measuring loan losses and thus contribute to the problem of financial reports that do not reflect the institutions' true financial condition.

The role of accounting is to report the facts. The troubled real estate market is a reality that has very much adversely affected the recovery values of collateral underlying nonperforming loans. Although writedowns of such assets to fair values will negatively impact bank capital, the result will be a more accurate picture of the banks' financial position.

The current focus and timing of FASB's efforts to address loan loss accounting are not adequately addressing the real time and critical needs of the regulators for reliable financial data. However, the regulators could exercise their authority under the FDIC Improvement Act to prescribe accounting rules that would facilitate more accurate financial reporting. Such actions would result in reports submitted to the regulators being prepared in accordance with both GAAP and regulatory accounting principles (RAP).

Generally, we do not advocate the use of accounting principles that differ from GAAP. However, the use of RAP in this instance would strengthen GAAP in the critical area of loan loss accounting and should not be confused with previous uses of RAP that weakened GAAP for savings and loans. Also, these revised rules would only apply to reports filed with the regulators. Ideally, using RAP to strengthen GAAP would be a temporary measure until FASB adopts the revisions we are advocating as GAAP for impaired loans.

Recommendations

We recommend that in implementing the FDIC Improvement Act, FDIC, FRB, OCC, and OTS change loan loss recognition and measurement rules for nonperforming loans used in preparing quarterly reports to the federal banking agencies to require that

- losses be recognized if they are more likely than not (a more than 50 percent probability of loss) to be incurred;
- current market prices be considered in the evaluation process for nonperforming loans and, if rejected because they are not considered representative of current market conditions in favor of discounted cash flows, a rational and convincing basis to support that decision be documented;
- discounted cash flow estimates be developed that reflect market-based discount rates commensurate with the risk of the cash flows projected when active markets do not exist; and
- appropriate periods of time reflecting periods needed to fully lease properties and cash flow projections which consider existing market conditions (with any projected improvements validated as reflecting likely market conditions) be used to develop estimates of fair values when active markets do not exist.

Matter for Congressional Consideration

Our review of failed banks, the administration's recent regulatory guidance for valuing commercial real estate, and the accounting rules that it appears FASB will propose for impaired loans, show that flexible accounting rules are a continuing problem that is contributing to financial reports that overstate assets and capital. The effectiveness of the FDIC Improvement Act will be diminished if accounting rules are not strengthened.

The Senate and House Banking Committees may want to urge the regulators to adopt accounting rules that will reflect the fair value of nonperforming loans for regulatory financial reports. The committees may also wish to urge FASB to adopt such accounting rules as the principles for impaired loans that are currently being developed. Absent the adoption of such accounting rules by either the regulators or FASB, the Congress may wish to hold hearings and consider legislating such requirements for financial reports prepared for the banking regulators.

Agency Comments

In commenting on a draft of this report, FDIC, FRB, OCC, and OTS generally agreed conceptually with the principles we believe accounting rules should follow in recognizing and measuring nonperforming collaterized loans. However, they believe that their practices, related requirements, or ongoing efforts to improve loan loss accounting are adequate to achieve proper evaluation of troubled loans. The regulators acknowledged that the applicable accounting rules were ambiguous and resulted in various applications. However, they believe that the accounting rules should be addressed by FASB or that the regulators' practices or ongoing efforts to clarify evaluation of troubled loans would resolve our concerns. The regulators referred to the November 1991 Interagency Policy Statement as an example of their most recent efforts to clarify evaluation of troubled loans. However, this policy statement emphasizes that markets in today's economic environment may not be representative of fair values and discourages the use of such transaction data in valuing troubled loans. Therefore, we remain concerned that many nonperforming loans are not being valued on a fair value basis and that this is resulting in overstated asset values and capital.

OCC questioned our comparing loss reserves derived from bank financial reports prepared prior to failure with FDIC loss estimates at the time of failure as valid evidence of overstated asset values and flexible accounting rules. We believe that the rules used to recognize and measure loan losses were a major factor in not reporting these losses on the balance sheets. However, internal control weaknesses contributed to delays in recognizing these losses, and the disruptive process in resolving failed banks is partially responsible for the different loss estimates.

The intent of our recommendations was to ensure that loan loss reserves more closely reflect economic reality in valuing and reporting assets to provide regulators with a timely and reliable basis for assessing the adequacy of bank capital and safety and soundness. The effectiveness of the regulatory reforms provided by the FDIC Improvement Act may be greatly limited by the flexible accounting rules that can be used to avoid or delay recognizing loan losses. It is critical that the regulators have reliable financial reports to take appropriate and timely regulatory measures to minimize losses to the insurance funds and, ultimately, taxpayers. The regulators' comments on our draft report reflect reluctance to require the changed loan loss rules for use in preparing reports to them. Accordingly, we have added a section on matters for congressional consideration regarding the risks presented to the insurance funds by deficiencies in

accounting rules and the federal banking agencies' reluctance to change such rules.

We are sending copies of this report to the Chairman and Ranking Minority Member, House Energy and Commerce Committee; the federal banking and thrift agencies; the Secretary of the Treasury; the Chairman, Securities and Exchange Commission; the Chairman of the Financial Accounting Standards Board; and the President of the American Institute of Certified Public Accountants.

This report was prepared under the direction of Robert W. Gramling, Director, Corporate Financial Audits, who can be reached on (202) 275-9406 if you or your staffs have any questions.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Contents

Abbreviations

AICPA	American Institute of Certified Public Accountants
ALLL	allowance for loan and lease losses
EC	Examination Circular
FASAC	Financial Accounting Standards Advisory Council
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FRB	Board of Governors of the Federal Reserve System
FRR	financial reporting release
GAAP	generally accepted accounting principles
GAO	General Accounting Office
OAEM	other assets especially mentioned
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
PB	practice bulletin
RAP	regulatory accounting principles
RTC	Resolution Trust Corporation
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standard

Recognition and Measurement of Loan Losses

Summary of GAO Concerns With Current Accounting Rules

In our recent study of 39 banks which failed in 1988 and 1989,[1] we found that the Federal Deposit Insurance Corporation's (FDIC) asset valuations, made after these banks failed, increased loss reserves from $2.1 to $9.4 billion. Internal control weaknesses contributed to delays in recognizing these losses. Also, the disruptive process and liquidation focus inherent in resolving failed banks is partially responsible for the different loss estimates. But we believe that the rules used to recognize and measure loan losses were a major factor in not reporting these losses on the balance sheets.

In commenting on our failed banks report, the Financial Accounting Standards Board (FASB) asked whether bank management's misapplication of generally accepted accounting principles (GAAP), such as "...questionable judgments made in assessing the collectibility of the loans, including determinations of the value of the underlying collateral, may have resulted in improper loan valuations." We agree that bank management, in concurrence with their auditors, may have made questionable judgments that resulted in instances of improper loan valuations. In reviewing the 39 failed banks, we found application problems on such a scale that the adequacy of accounting rules must be called into question. Ambiguities in accounting rules facilitate the questionable judgments and make it difficult for auditors to refute them; however, the problem is not limited to ambiguities in the application of existing rules.

Bank management should provide meaningful and accurate financial reports which reveal the full amount of losses when they are incurred. Bank examiners and independent auditors have a significant role to play in challenging management's assumptions and loss reserves and in verifying that financial reports reflect GAAP. The Financial Accounting Standards Board, and to a lesser extent the American Institute of Certified Public Accountants, are responsible for developing the framework of GAAP applied by bank management, auditors, and bank examiners. Through their examination and supervision rules, bank regulators further define GAAP and provide guidance on applying it. A cooperative effort is required, with each participant discharging responsibilities to foster fair financial reporting. FASB's efforts are vitally important in clearly stating the accounting rules that provide the basic framework within which bank management, auditors, and bank examiners discharge their critical financial reporting, attest, and examination functions.

[1] Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991).

We are concerned that the accounting rules set by FASB for recognition and measurement of loan losses do not call for recognition of the fair value of all nonperforming loans and do not properly apply or clearly define the following terms: "probable," "net realizable value," "fair value," "active market," and "foreseeable future." Dealing with these deficiencies properly is essential for meaningful financial reporting. This is particularly important for banks and savings and loans where large segments of the industry are experiencing severe financial distress, but it is also important for other industries, such as the insurance industry, that include significant amounts of loan-related assets on their balance sheets.

Until accounting rules are clarified for banks and savings and loans, federal regulators may not recognize the extent of the financial problems in our nation's depository institutions until they become so severe that the current accounting rules can no longer hide them and the losses to the insurance funds cannot be prevented or minimized. Conversely, until the rules are improved and clarified, with ambiguities eliminated, the regulators may be delaying regulatory actions (forbearance) through their own policies that seemingly comply with GAAP. Independent public accountants are also limited in their ability to assist in fair reporting as the wide latitude of accounting rules makes it difficult to insist on reserve amounts which adequately cover impaired assets. As financial problems in depository institutions become more severe, institutions have a greater incentive to take advantage of the accounting rules to avoid recognizing loan losses. While loan loss accounting is necessarily judgmental, the range of acceptable application must be narrowed, with resultant loan loss reserves coming closer to reflecting economic reality.

Our specific concerns regarding accounting rules for loan loss recognition and measurement are as follows.

- The "probable" criteria interjects a bias against recognizing losses, thus delaying their recognition. Also, the probable criteria for loss recognition is subject to considerable interpretation, unnecessarily contributing to inconsistent application.
- Reference to undiscounted cash flows required by the definition of "net realizable value" in measuring losses from problem loans, rather than to fair values, contributes to delays in recognizing loan losses and understates them when they are finally recognized.
- Ambiguities in determining when an "active market" exists allow financial statement preparers to improperly reject the evidence of current trading

market values in measuring fair values in favor of using judgmental cash flows to derive fair value estimates.

- Use of projections of cash flows that consider estimated market conditions which may exist in the "foreseeable future" allows an optimistic view of economic improvements that may occur in the distant future.

FASB is working on a project which addresses loan impairment and accounting rules for the recognition and measurement of losses. However, FASB has tentatively concluded that the probable criteria will not be changed. Further, measurement of losses using fair values which sufficiently reflect existing trading market conditions is not now explicitly required in the FASB loan impairment project. Therefore, as matters now stand, FASB's current project will not fully address our concerns.

FASB's Impairment of a Loan Project As Currently Proposed Does Not Fully Address GAO Concerns

The tentative decisions of FASB reflected in a January 27, 1992, initial draft of the standards section of the "Accounting by Creditors for Impairment of a Loan" Exposure Draft are intended to improve loan loss accounting.[2] But much remains to be done. The following is a summary of our views of the proposed standard as currently drafted.

- Under the standard, losses would be recognized when it is probable that a creditor will be unable to collect all accounts due according to the contractual terms (that is, including interest) of the agreement or when the loan has been modified in a troubled debt restructuring. However, minor shortfalls in timing or amount of cash flows will not cause losses to be recognized.
  - Nonperforming loans have been the focus of much of our attention. Provided that the exception for minor shortfalls is unambiguously defined to mean truly insignificant amounts, FASB's recognition criteria appear to encompass all nonperforming loans evaluated on an individual basis.
  - We continue to believe that the probable criteria should be changed to a "more likely than not" (a more than 50 percent probability of loss) criteria. Reiterating that probable does not mean virtually certain (paragraph 8 of the draft standard) is not sufficient guidance for assessing performing loans for possible impairment.
- FASB is not specifying how entities should identify loans to review for impairment.

[2]As modified for FASB decisions reached through May 20, 1992.

- We believe that some qualitative criteria should be provided for use in identifying loans which have not yet reached nonperforming status but should be reviewed for possible impairment.
- We believe that the concepts in the draft standard as adjusted to reflect the views in this paper also should be applied to pools of loans. Guidance on how to do this through a sampling or other approach would be helpful.

- Losses would be measured by the difference between an estimate of a loan's present value (using best estimates of cash flows and the effective interest rate for the loan) and the loan's carrying amount for all but formally restructured loans, for which fair value would be the measurement focus.
  - We concur with FASB's decision to reject undiscounted cash flows as a measurement focus in accounting for loan losses.
  - We do not support use of effective rates in developing loss reserves. We advocate the use of a fair value estimate in measuring loan losses, and we believe that transaction prices in active trading markets should sometimes be used instead of cash flows and should always be considered as a reality check on present value determinations based on cash flows. If transaction prices exist, or transactions prices can be inferred by reference to comparable markets, they should be used or referred to. We believe this is particularly appropriate for secured nonperforming loans. If transaction prices cannot be used, then market interest rates should be used to discount cash flows to derive a fair value estimate.
  - We believe it is inappropriate to measure losses for formally restructured loans using fair values, while measuring losses from other impaired loans which are "in substance restructured" (albeit involuntarily by the debtor) using present value estimates based on the effective interest rate on the loan. In periods of rising interest rates, management will be reluctant to formally restructure loans, because the existing present value-based loss estimates using effective interest rates will be lower than that required to adjust the loan carrying amount to fair value. Conversely, in periods of falling interest rates, management will have an incentive to give concessions to debtors and formally restructure debt solely to record the gain which will result. The opposite but analogous situation which currently exists for foreclosures, wherein management has an incentive to modify debt agreements to avoid loss recognition, gave rise to the

concept of in substance foreclosures and the requirement that in substance foreclosures be accounted for using fair values.[3] We believe that loans which are impaired are, in effect, in substance restructured, and like restructured loans must be subject to remeasurement using fair values. Any other practice is subject to abuse.

- If the draft is revised to require reference to market interest rates, fair values, and transactions in active markets as we suggest, then a definition of active market which excludes "fire sale" situations should be provided.
- While the draft requires use of management's best estimates of cash flows, insufficient guidance is provided to aid in developing or challenging such estimates. If more explicit use of transactions data (as we strongly recommend) is not required, FASB should specify how "reasonable and supportable" assumptions and market interest rates are to be derived. Appropriate limitation on foreseeable future should also be provided to avoid hypothetical market assumptions that are not reasonable. A period of time for lease up periods that reflect current market conditions is acceptable.

As currently drafted, FASB's proposal would improve loan loss accounting. However, we are concerned that the standard will not be successful in developing meaningful loss estimates.

Changes in FASB's proposal as it evolved since January 1992 have significantly increased our concern that the standard, when ultimately issued, may only marginally improve loan loss accounting and will not be successful in developing meaningful loss estimates. In contrast to the current status, at one time, FASB had tentatively decided that market interest rates should be used to derive loss reserve estimates. This approach can be seen as analogous to developing fair value estimates when transaction prices are unavailable. Use of market interest rates would have supported development of loss estimates and loan carrying values which reflect economic reality. The use of an effective rate for the loan will lose the linkage to fair values and economic reality and once again set the stage for reporting loans at unrealistic values. In tentatively rejecting the use of market interest rates, FASB has lost completely the link to economic reality.

[3]The proposed standard will eliminate the requirement that in substance foreclosed assets be accounted for as foreclosures with losses recognized using fair value concepts. Losses will instead be measured, as with all impaired loans, using present values based on the loan's effective interest rate. We agree that eliminating the distinction in carrying amount between other impaired loans and in substance foreclosed loans may have merit because of the implementation issues in determining when a loan is in substance foreclosed. However, fair values better reflect economic reality and should not be disregarded because in substance foreclosure guidance requires judgments to apply it.

Reference to fair values and market prices in the standard would have provided such a link. Therefore, FASB has significantly weakened the proposed standard. Users will not be served by accounting standards which obscure economic reality and which make it impossible to determine the true financial condition of banks.

The analysis included in the balance of this report deals more completely with the problems in the present guidance and in the FASB loan impairment proposal. Although there is great urgency to establish improved rules, we believe our suggestions should be thoroughly considered and, if not accepted, be specifically dealt with by FASB in its exposure draft. The Federal Deposit Insurance Corporation Improvement Act of 1991 (Public Law 102-242) requires the federal regulators to review the adequacy of accounting principles used by depository institutions by December 19, 1992. The SEC, as well, has an interest in the adequacy of the present rules. We encourage FASB to work with these government representatives to develop accounting rules that result in financial statements that fairly present the condition and performance of depository institutions.

Accounting Rules for Loan Loss Recognition and Measurement

FASB's "Statement of Financial Accounting Standards No. 5, Accounting for Contingencies" (SFAS No. 5) and "Statement of Financial Accounting Standards No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings" (SFAS No. 15) are the primary sources of GAAP which address loss recognition. In addition, the American Institute of Certified Public Accountants' (AICPA) 1983 industry audit guide, Audits of Banks (bank audit guide), and 1991 industry audit guide, Audits of Savings Institutions (savings and loans audit guide) address the application of GAAP to the banking and savings and loan industries, respectively. While the savings and loans audit guide contains a useful discussion on identifying troubled loans and some guidance on making net realizable value determinations, the industry audit guides provide little specific additional guidance on loss recognition. Similarly, an AICPA auditing procedure study, Auditing the Allowance for Credit Losses of Banks, incorporates the fundamental loss recognition and measurement principles in SFAS 5 and SFAS 15 and provides illustrative implementation guidance. Therefore, our analysis primarily focuses on SFAS 5 and SFAS 15, and related authoritative guidance, including the Securities and Exchange Commission's Financial Reporting Release No. 28, "Accounting for Loan Losses by Registrants Engaged in Lending Activities" (FRR-28).

Ambiguities in the SFAS 5 Definition of Probable Deter Loss Recognition

The probable definition is a key determinant in SFAS 5 for recognition and measurement of losses. In its draft loan impairment standard, FASB has retained the probable criteria, while reiterating that virtual certainty is not required for loss recognition. Also, SFAS 5 would be amended to clarify that the term "all amounts due" means including all future interest payments as well as all principal payments in accordance with contractual terms. As a result, nonperforming loans (with an exception for minor shortfalls in the timing or amount of cash flows) will automatically be subject to impairment measurement under the proposed standard. Our continuing concerns with the probable threshold, assuming adoption of the proposed standard, is that it sets too high a threshold for use in reviewing other troubled loans for impairment and is ambiguously defined. We are also concerned that the exception for minor shortfalls in timing or amount of cash flows will not be unambiguously defined by FASB to include truly insignificant amounts.

Paragraph 8 of SFAS 5 requires that an estimated loss from a "loss contingency" be charged to income if the condition giving rise to the loss is probable and the amount of the loss can be "reasonably estimated." A "loss contingency" is defined in paragraph 1 as "...an existing condition, situation, or set of circumstances involving uncertainty as to (possible loss) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur." Paragraph 23 goes on to demonstrate this concept as it relates to the collectibility of receivables, as follows:

"If, based on available information, it is probable that the enterprise will be unable to collect all amounts due, and therefore, that at the date of its financial statements the net realizable value of the receivables through collection in the ordinary course of business is less than the total amount receivable, the condition in paragraph 8(a) is met because it is probable that an asset has been impaired."

A June 1991 discussion paper prepared by the Federal Deposit Insurance Corporation provides an indication of how SFAS 5 is applied by regulators and illustrates the diversity in views and confusion as to what probable means:

"Although the term 'probable' is used in other circumstances in GAAP, no more precise definition is provided in accounting literature. The New World Dictionary (Second Edition) defines 'probable' as 'likely to occur or be; that can reasonably but not certainly be expected.' Webster's New Collegiate Dictionary defines it as 'supported by evidence strong enough

to establish a presumption but not proof.' Some others have suggested that 'likely' may be further described as 'more than a 50 percent chance of occurring.'

"However, SFAS No. 5 states that when a loss contingency exists, the likelihood that the future event will occur to confirm the loss is within a range. It identifies the range as consisting of three areas: probable, reasonably possible, or remote. On that basis, if proportional mathematical equivalents for the range were to be determined, it would mean that more than a 66 percent chance of an event occurring would be probable, over a 33 percent chance to a 66 percent chance would be reasonably possible, and a 33 percent chance or less would be considered remote. However, there is nothing in SFAS No. 5 to suggest that the three areas comprising the range of likelihood should be divided in this manner. Although the 'probability' of loss is essentially based on the individual's judgment and cannot be determined with mathematical precision under GAAP, both a bank and thrift should establish and maintain a reserve for a loan or pool of loans when, based on currently available information, it is 'probable' that a loss has occurred and the amount of the loss can be reasonably estimated."

The lack of clarity of the term probable is further demonstrated by a recent survey of Financial Accounting Standards Advisory Council (FASAC) members. Sixteen of twenty-six FASAC members who had formulated an opinion concurred in a survey following their June 1991 meeting that:

"The requirement that a loss be probable before it is reserved has, in the case of banks, come to mean 'virtually certain' rather than 'more likely than not'."

The survey results reflected disparate views, with some participants indicating that existing guidance was adequate and others believing that accounting literature should be changed. FASB has stated that it did not intend for probable to mean virtually certain to occur. We recognize that FASB did not intend that virtually certain be the criteria applied in assessing impairment. We also recognize that some accountants interpret probable and likely to occur as synonymous with more likely than not. FASB acknowledges there is some leeway in practice about how to interpret the term probable. FASB also has stated that it was aware when SFAS 5 was issued that the judgment required by the statement would produce differences in estimates.

Our concern with the probable definition is how institutions determine when to recognize losses when loans are analyzed on a loan-by-loan basis. We are concerned that the probable threshold is too high and is ambiguously defined and applied in practice.[4]

Notwithstanding that SFAS 5 does not require that a loss be virtually certain to be recognized, applying the probable criteria in a loan-by-loan analysis results in biased estimates of true losses that have occurred in loan portfolios. Within the context of recognizing losses which arise from the routine business of banking, the probable threshold is too high. A more evenhanded approach will result in earlier recognition of losses and more relevant financial reporting for banks. In addition to fostering a bias against recognizing loan losses, the ambiguity in the meaning of probable has clearly led to a diversity in practice. Adoption of a more likely than not criteria will provide a lower threshold for recognizing losses and will tighten the level of loss possibility which triggers loss recognition. We recognize that loan loss recognition will continue to require substantial judgment, but that judgment will focus on assessing the possibility of loss, rather than also on what probable means.

In addition to being discussed as an alternative definition to probable in FASB's "Discussion Memorandum on Accounting for the Impairment of Long-Lived Assets and Identified Intangibles," the more likely than not criteria has been used by FASB in connection with recognizing deferred tax assets. In SFAS No. 109, "Accounting for Income Taxes," the FASB requires recognition of deferred tax debits as assets subject to a more likely than not recognition and valuation test. We have not thoroughly studied the merits of recognizing such deferred tax debits, particularly when they arise from deductions which create net operating loss carryforwards. However, it appears to be inconsistent to require that loan losses be probable to be recognized, while tax benefits of such loan losses resulting in net operating loss carryforwards need only be more likely than not to be recognized.

We understand that as part of FASB's loan impairment project, it will reiterate that probable does not mean virtually certain. However, this will not ensure consistent and proper loan loss recognition. We encourage FASB

[4]As part of their analysis, financial statement preparers generally develop an estimate of losses for pools of loans by considering prior experience with similar pools of loans. Determinations of loss reserves for pools of loans are generally based on a simultaneous reference to default statistics (the number of the loans which will default) and losses for defaulted loans. These estimates are developed without the bias introduced by the accounting literature through the probable definition.

to make explicit that the probable definition "... likely to occur" is intended to imply that losses should be accrued if they are "more likely than not." As noted by one of the FASAC respondents to its June 1991 survey, adding a numerical criteria may be helpful.

The possibility of loss must be identified before it is subject to the more likely than not recognition criteria. In that respect, as will be discussed later, the use of net realizable values to measure losses does not reflect present value concepts and so economic losses may not appear to exist. Use of fair value concepts as a starting point in both recognizing and measuring losses and then requiring that a loss be recognized if it is more likely than not would result in more timely and realistic recognition and measurement of loan losses from problem loans. We believe that the role of the more likely than not criteria is to assess mitigating factors management does not explicitly recognize in developing loss estimates based on fair value concepts.

Net Realizable Values (Undiscounted Cash Flows)—an Inappropriate Measure in Identifying Problem Loans

In addition to the probable criteria, the concept of net realizable value is another key determinant in SFAS 5 for recognizing and measuring losses. FASB's proposed Loan Impairment Exposure Draft would reject the use of net realizable values (undiscounted cash flows) in identifying or measuring losses from problem loans. In its place, FASB will require a present value based estimate developed using management's best estimates of cash flows and effective interest rates. If the proposed standard is adopted, our concerns with SFAS 5 and SFAS 15 as discussed below will be reduced. However, because the linkage between these present value based estimates and fair values which reflect market transactions is not made, the measurement focus in the impairment of a loan project is not responsive to our concerns.

Pursuant to SFAS 5, losses are recognized when they can be reasonably estimated and it is probable that net realizable values are less than recorded amounts due. Paragraph 6 of FASB Concept Statement No. 5 defines net realizable value as "the nondiscounted amount of cash, or its equivalent, into which an asset is expected to be converted in due course of business less direct costs, if any, necessary to make that conversion." The AICPA's savings and loan audit guide explicitly recognizes interest as a cost to be recognized in net realizable value computations for use in both recognizing and measuring losses. However, the AICPA's bank audit guide is silent in this regard, so that banks may continue to use undiscounted cash flows. In commenting on this report, OCC asserted that industry practice

for collateral dependent real estate loans has now evolved to the point where undiscounted cash flows are seldom used. However, OCC was unable to provide documentation to support this assertion.

Accounting rules do not otherwise explicitly define net realizable value within the context of the recognition of loan losses. Further, accounting rules do not explicitly prescribe a method for measuring the amount of such losses. However, it can be inferred from SFAS 5 that implicit in the definition of a loss is the concept that the loss is measured as the difference between the recorded amount and net realizable value. Accordingly, in determining whether to recognize a loss and in measuring such losses, banks can initially compare the undiscounted stream of cash expected to be received from the borrower to the recorded amount of the loan and any interest currently due. Under GAAP, if aggregate cash estimated to be received in the future exceeds the recorded amounts due, there is no loss to recognize or measure. This is true even if future scheduled interest payments will not be received. FASB has preliminarily decided to change this recognition criteria to reflect the time value of money in its impairment of a loan project.

The net realizable value or undiscounted cash flow concept is reinforced in SFAS 15 which provides guidance recognizing and measuring losses, but only in the context of troubled debt restructurings.[5] Paragraph 31 states:

"If...the total future cash receipts specified by the new terms of the receivable, including both receipts designated as interest and those designated as face amount, are less than the recorded investment in the receivable before restructuring, the creditor shall reduce the recorded investment in the receivable to an amount equal to the total future cash receipts specified by the new terms."

The converse of this statement is in paragraph 30, which states:

"A creditor in a troubled debt restructuring involving only modification of terms of a receivable...shall account for the effects of the restructuring prospectively and shall not change the recorded investment in the

[5]In accordance with paragraph 2 of SFAS 15: "a restructuring of debt constitutes a troubled debt restructuring .... if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court."

receivable at the time of the restructuring unless that amount exceeds the total future cash receipts specified by the new terms."

In effect, paragraph 30 of SFAS 15 allows a creditor to grant concessions to a debtor, such as extension of the loan payment term and/or reduction of the interest rate (even to the extent of a non-interest bearing loan), while not recognizing a loss on the restructuring, provided that the recorded loan balance will be repaid in full under the new terms. For example, assume Bank X has an outstanding loan for $10 million to Developer Y at an interest rate of 12 percent, due in 18 months. Current interest rates for this type of loan are at 10 percent. Developer Y has experienced numerous delays on the project and significant cost overruns. Bank X agrees to extend the term of the loan for another 48 months and to reduce the interest rate to 5 percent. No loss would have to be recorded to reflect these concessions under existing criteria, even though the terms are more favorable than current market terms. Implementation of FASB's impairment of a loan project will lead to correction of this inappropriate result.

Undiscounted cash flow is an inappropriate measure for identifying problem loans and measuring losses because it delays recognition of economic losses an institution may incur to hold a problem loan. Accordingly, the definition of net realizable value in the accounting rules is not appropriate for use in loan loss accounting because it does not provide guidance in determining a time frame for recovery of amounts due and precludes discounting. It is our view that a loan is considered impaired when the contractual amounts due (principal and interest) more likely than not will not be collected.

In making this determination, we believe that losses from unsecured impaired loans should be measured by comparing the estimated discounted recoverable amount of the loan, after all collection and holding costs, to the recorded amount of the loan. For secured loans, it is our view that the use of fair value should have broader application in development of loan loss reserves. Frequently, the most important indication of the debtor's willingness to continue to meet contractual terms for a secured loan is the relationship of the fair value of any underlying collateral to contractual amounts due. Evidence of a borrower's ongoing willingness and ability to continue to repay the loan, through payment of all prior amounts contractually due, other borrower funding for the loan and guarantees should be considered. A loss need not necessarily be recognized for collateral shortfalls for performing loans. When a collateralized loan is nonperforming, and such mitigating factors do not exist, the fair value

concepts discussed below which are applicable in applying in substance foreclosure guidance should be used in measuring losses.

FASB has tentatively decided in its project on impairment of a loan that a creditor should measure impairment of a loan based on the present value of expected future cash flows using the effective rate of interest of the loan. While we disagree with the interest rate selected, we support FASB's initiatives to change the amount of losses to recognize for problem loans by discarding the notion that the amount of such losses can be measured by comparing an undiscounted stream of estimated cash flows to the carrying amount of the loan. The recognition of the time value of money is an appropriate and critical factor in developing meaningful loan loss reserves. That tentative decision could lead to amending SFAS 5 and would amend SFAS 15.

Accounting rules being considered in the impairment of a loan project may lead to earlier identification and recognition of losses. However, under the impairment of a loan project, losses would be measured using discounted cash flow concepts. We believe that identification of impairment represents an accounting event which should be measured utilizing fair values. FASB's proposed use of discounted cash flows using the effective rate of the loan is not a fair value method. The proposal also does not make any reference to the role of active markets or preferability of using transaction prices in active markets. Similarly, while the proposed standard will lead to the use of discounted cash flow concepts, it is silent regarding what reasonable and supportable assumptions entail. The meaning of foreseeable future within the context of developing FASB's present value estimates or fair value estimates and the role that current conditions play in developing such estimates is also not addressed.

Key Factors for Determining Fair Value Need To Be Defined

At present, fair value[6] concepts are introduced into loan loss recognition and measurement only in the case of restructurings which result in settlement of the debt by foreclosure on any related collateral or by what is referred to as "in substance" foreclosure. Paragraphs 28, 33, and 39 of SFAS 15 require fair value accounting for assets received in satisfaction of a

[6]Fair value is the amount that the debtor could reasonably expect to receive in a current sale between a willing buyer and a willing seller other than in a forced or liquidation sale. While the term "current sale" is not further defined, this time constraint in the definition of fair value is more restrictive than the open ended "due course of business" reference in the net realizable value definition. Additionally, discounting concepts, while not required in net realizable computations for banks, are inherent in the determinations of fair values.

receivable. The amount of the recorded investment in the receivable is compared to the fair value of repossessed collateral, with a loss recognized if the fair value is less than the recorded investment. Paragraph 13 of SFAS 15 describes the measurement of fair value as follows:

"Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling price in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved."

The determinants of an active market are not defined in accounting rules. This provides too much leeway to inappropriately ignore transaction prices in determining fair values. This issue will be discussed more fully later. Also, because measurement of the loss from a problem loan which is foreclosed changes from an undiscounted cash basis to a fair value basis, the amount of loss recognized can increase significantly. Because formal foreclosure on problem loans may result in recognition of large losses, reducing a bank's earnings and capital, an incentive exists for management to delay such foreclosures. This problem is recognized in accounting rules by requiring that loans which are in substance foreclosed be treated as foreclosed loans for purposes of loss recognition. Paragraph 34 of SFAS 15 requires that a restructuring which, in effect, represents a foreclosure by the creditor should be accounted for as though actual foreclosure has occurred:[7]

"A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to the provisions of paragraphs 28 and 33 and, if appropriate, 39."

SFAS 15 is clear that fair value accounting is required when a loan restructuring is in substance a foreclosure. However, SFAS 15 does not provide criteria for determining when an in substance foreclosure or repossession has occurred. The concept of in substance foreclosure received little or no attention until December 1986 when the Securities and

[7]The concept of in substance foreclosures embodied in paragraph 34 of SFAS 15 would be rescinded under FASB's impairment of a loan project.

Exchange Commission (SEC) issued Financial Reporting Release No. 28, "Accounting for Loan Losses by Registrants Engaged in Lending Activities" (FRR-28). This release expressed the SEC's views on the valuation and accounting for repossessed loan collateral whether the repossession (foreclosure) is done formally or substantively. The release applies to all companies subject to SEC oversight.

SEC was concerned that some SEC registrants were using SFAS 15 to inappropriately avoid loss recognition on certain loans. This concern is expressed, in part, as follows:

"The Commission has become aware that...some registrants may believe that no loss need be recognized on [certain problem loans], on the basis that there is always the option of modifying the terms of the loans to call for repayments which, on an undiscounted basis, would eventually recover the carrying value of the loans. Should that option be exercised, some have argued, no loss recognition would be required under the provisions of paragraphs 30 and 31 of SFAS 15."

"A registrant cannot avoid the fair value accounting required by SFAS 15 when collateral is repossessed, simply by avoiding a formal repossession. That concept is clearly expressed in paragraphs 34 and 84 of SFAS 15, although it is expressed there in the context of a formal debt restructuring. Collateral that has substantively been repossessed should be accounted for in the same manner as collateral that has been formally repossessed, irrespective of whether the related loan is formally restructured."

FRR-28 established the following criteria for determining when a loan should be considered in substance foreclosed and therefore accounted for at fair value.

1. The debtor has little or no equity in the collateral, considering the current fair value of the collateral.

2. Proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral.

3. The debtor has either

(a) formally or effectively abandoned control of the collateral to the creditor, or

(b) retained control of the collateral but, because of the current financial condition of the debtor, or the economic prospects for the debtor and/or the collateral in the foreseeable future, it is doubtful that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future.

Unfortunately, the term foreseeable future is not defined in the accounting rules other than through a circular reference in FRR-28 that any assumptions must be expected to be attainable within an (undefined) reasonably manageable future period.

We are concerned about the use of optimistic cash flow assumptions that ignore active markets and ambiguities in determining how far into the future preparers may go in projecting a recovery in real estate markets. The absence of guidance on the meaning of active market and foreseeable future contributes to under recognition and measurement of real losses.

We believe that the fair market value of collateral for secured loans should be considered in determining loss reserves. In situations where no market exists for the collateral, fair value may be determined based on a discounted cash flow analysis. We further believe that the stream of cash flows for the collateral should be determined based on the existing condition of the collateral, unless there is clear evidence to support estimates of changed conditions.

We concur with FASB's tentative decision in the impairment of a loan project to recognize discounting concepts in measuring losses from problem loans insofar as it would apply to illiquid unsecured loans. However, we believe that market interest rates should be used in developing such estimates. In addition, for loans with an active market, for either the loan itself, or the underlying collateral (when the recoverable amount of the loan is less than the collateral value), we do not believe the discounting approach is appropriate. For such loans, the use of measures that subjectively estimate streams of cash flows, rather than using potentially more objective indicators of value from recent transactions, will inappropriately be the determining factor used in measuring the amount of losses to recognize for collateralized loans. The marketplace provides a meaningful measure of value, with prices reflecting both estimates of cash flows made by market participants and discount rates commensurate with the risks of these cash flows.

The use of effective interest rates as part of the measurement focus in the loan impairment project thwarts the objective of reporting loss reserves which reflect economic reality. Further, we are concerned that FASB's approach to the loan impairment project may not preclude use of what appears to be an overly optimistic approach inherent in the recent interagency policy statement regarding valuation of income producing property.[8] In that case, unrealistic loan loss estimates could be defended as meeting GAAP. Whenever possible, we believe that existing market conditions must be reflected in loss reserve estimates. The best way to do this, we believe, is by reference to transaction prices in the marketplace for similar loans and collateral.

To ensure more objective and realistic use of transaction prices, the determinants of an active market and foreseeable future must be clarified with preparers required to rebut the presumption that transaction prices provide a consensus indicator of value. To show the significance of these terms, the following examples illustrate the wide variances that can exist as a result of the present application of the terms active market and foreseeable future in applying the in substance foreclosure guidance and loss recognition and measurement concepts of FRR-28.

Assume the same situation discussed earlier regarding Bank X agreeing to restructure Developer Y's $10 million loan. In that example, the interest rate was reduced from 12 percent to 5 percent and the loan term was extended another 48 months. The current market interest rate is 10 percent. Assume that the project is 20 percent leased; the current annual net cash flow is $200,000; the current market absorption rate is 20 percent; and there is no other means of repayment of the loan other than the project. The project is expected to be fully leased in 48 months (when the loan is due) with a projected annual cash flow at that time of $1.25 million. Rental increases are anticipated after the next 24 months.

Assume that the first two criteria under FRR-28 have been met, with an appraisal or other evidence indicating that the borrower has no current equity in the collateral, and there is no other source of repayment other than the project. The borrower has not abandoned the property (criteria 3a), and, therefore, the final determination rests on criteria 3b: "...it is

[8]"Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, and Office of Thrift Supervision, dated November 7, 1991.

doubtful that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future."

Criteria 3b is evaluated based on the borrower's ability to repay all amounts due in the foreseeable future on the basis of cash flows. Assuming the project's expectations are reasonable, this evaluation would be performed as follows:

	Current	12 months	24 months	36 months	48 months
Net cash flow	$200,000	$400,000	$600,000	$900,000	$1,250,000
Debt service	500,000	500,000	500,000	500,000	500,000
After debt service	**(300,000)**	**(100,000)**	**100,000**	**400,000**	**750,000**
Direct capitalization value ($1.25 mil at 10 percent)					$12,500,000
Excess cash flows after debt service (sum of above)					850,000
Net cash flow available to repay loan					**$13,350,000**

In this case, the loan does not meet the in substance foreclosure criteria, as the borrower appears to have the ability to rebuild equity, assuming that 48 months is considered to be within the foreseeable future and that the projected cash flow assumptions are supportable. Under existing GAAP, no loan loss reserve is required.

The concept of foreseeable future is further discussed on page 10 of the FRR-28:

"Because assumptions underlying forecasts become less reliable as they look farther into the future, the word 'foreseeable' in criterion 3(b) establishes that any relied-upon assumptions must be expected to be attainable within a reasonably manageable future period."

Judgments will differ about what constitutes a reasonably manageable future period. To illustrate the impact of this diversity, assume that a reasonable period of time to evaluate the borrower's ability to rebuild equity is 36 months. In this case, the net cash flows available to repay the loan would be as follows:

Direct capitalization value ($900,000 at 10 percent)	$9,000,000
Excess cash flows after debt service	100,000
Net cash flow available to repay loan	$9,100,000

Based on the above scenario, the borrower does not have the ability to rebuild equity in the foreseeable future, and therefore the loan meets the in substance foreclosure criteria and must be written down to fair value. In accordance with SFAS 15, if there is an active market, then the loan would be valued accordingly. Assume that projects of this type are currently selling for $10 per square foot of leased space and $8 per square foot of unleased space. If the project has 500,000 square feet and is 20 percent occupied, then the fair value would be $4.2 million and a writedown of $5.8 million would be required. The significant difference between the value derived from estimated cash flows ($9.1 million above) and fair value ($4.2 million) suggests the market rate used for capitalization or projected cash flows should have been further adjusted for risk in the market.

In markets which have declined from previous high levels, market prices based on current transaction data can be far below an institution's carrying amount for a loan, thus providing an incentive to disregard such data. Disregarding such data can only be done by determining that no active market exists. There are no specific guidelines available for determining when no active market exists. While the SEC in FRR-28 specifically states that an auction market of collateral should be considered relevant transaction data for use in determining fair value, there is a significant incentive to disregard transaction data. If it was determined that no active market existed for this type of project, then, in accordance with SFAS 15, a discounted cash flow approach, perhaps using a higher discount rate would be used, as follows:[9]

Present value of $9,000,000 (from above) discounted at 12 percent (risk adjusted) over 3 years	$ 6,290,000
Present value of cash flows (before debt service)	1,657,000
Estimated fair (current market) value	$ 7,947,000
Loan balance	10,000,000
Required writedown	$ 2,053,000

The above examples are very simplified and do not consider numerous other factors such as selling costs, holding costs (including interest holding costs, which would be factored in under the AICPA savings and loans audit

[9]Paragraph 13 of SFAS 15 states that "if no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets ... provided that the expected cash flows are discounted at a rate commensurate with the risk involved." No explicit definition of how to develop the discount rate is provided in the accounting rules, which has led, as discussed later in this section, to rejection of discount rates which reflect returns investors may require in troubled markets, in favor of hypothetical "normal" discount rates reflecting market stabilization and recovery.

guide), tenant improvements, rent concessions, and revenue/expense escalation factors. However, they serve to demonstrate the broad range of values which can be determined for a given real estate project, depending on the interpretation of foreseeable future, and the determination of whether an active market exists. More extreme valuations could be justified using slightly different capitalization and discount rates.

No other guidance has been provided in the accounting literature as to what constitutes the foreseeable future or an active market. The AICPA issued Practice Bulletin 7, "Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed" (PB-7) in April 1990. PB-7 is basically a reiteration of FRR-28 and extends the concepts introduced in FRR-28 to nonpublic companies. The only new information of significance is the suggestion that the tax aspects of transactions should be considered in determining a debtor's probability of repaying.

The loan loss provisions in the above illustrations would change under FASB's impairment of a loan project. For example, if the loan discussed on page 33 was considered impaired because cash flow is inadequate to service the loan in the first 2 years or a troubled debt restructuring has occurred, pursuant to FASB's impairment of a loan project a discounted cash flow approach would be used to derive a present value estimate and a required loan loss reserve. As discussed below, it is our view that the required reserve should reflect fair values and be developed by reference to transaction prices in the marketplace. This approach is taken elsewhere in GAAP in developing fair value estimates—deference is generally given to transaction prices in active markets.

It is not clear to us how the impairment of a loan project will deal, if at all, with disparities between derived present value measurements of loan impairment and measures provided by the market place as discussed in the example on page 34. It is clear to us that such disparities will call into question the usefulness of bank financial reports and the adequacy of loan losses. The traditional initial reference to transaction based fair value measures is not required in the proposals FASB is considering. Instead, FASB has chosen to treat the reserving process in the abstract as merely an accounting allocation. This approach disregards economic concepts and seriously weakens FASB's proposal.

Federal Regulatory Guidance for Valuing Real Estate Loans May Exacerbate Weaknesses in Accounting Rules

Federal regulators' guidance to examiners and depository institutions illustrates how flexible accounting rules are for loan loss recognition and measurement. We considered Office of the Comptroller of the Currency (OCC) guidance released in 1985 and 1987 relating to troubled real estate loans. Also, we considered the 1991 joint statement of OCC, FDIC, the Board of Governors of the Federal Reserve System (FRB), and the Office of Thrift Supervision (OTS), "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans." As discussed below, subsequent to initial circulation of a draft of this report in March 1992 to the regulators for comment, the OCC formally amended certain of its guidance to examiners for accounting for troubled real estate loans.

On October 30, 1985, OCC issued Examining Circular No. 234, "Guidelines for Troubled Real Estate Loans" (EC-234). The stated purpose of EC-234 was to reiterate OCC's policy and provide guidance to examiners in reviewing troubled real estate loans. This circular was issued at a time when many banks were faced with growing problems in their loan portfolios due to an oversupply of commercial real estate. It provided a discussion of indicators of troubled real estate loans, guidelines to be used in appraisal analysis of such loans, and classification guidelines to be utilized for commercial real estate loans.

On July 10, 1987, Supplement No. 1 to EC-234 was issued in order to clarify certain aspects of the original circular, including 'Classification Guidelines' which do not delineate sufficiently between properties where value impairment is temporary or permanent." Another significant difference between the original guidance issued in 1985 and the supplement issued in 1987 is the discussion and definition of the "loss" classification for troubled real estate loans.

The 1985 guidelines defined "loss" in situations where the obligor has no means of repayment other than the project, as follows:

"Advances, in excess of calculated current fair value which are considered uncollectible, do not warrant continuance as bankable assets. There is little or no prospect for near term improvement and no realistic strengthening action of significance pending."

The 1987 guidance clarifies the above definition to "distinguish between value impairment that is deemed to be permanent, and uncollectible, versus that which is viewed as temporary."

"Accordingly, 'Loss' classifications should reflect permanent value impairment, i.e., loan exposures exceeding the undiscounted future market value expected to be realized within a reasonable period of time, normally not to exceed five to seven years (emphasis added). The difference between the undiscounted future market value and current fair market value should normally be classified as 'Doubtful', with the balance of the loan passed or criticized as Other Assets Especially Mentioned (OAEM) or Substandard, depending on the examiner's assessment of relevant credit factors."

Because the net realizable value loss recognition focus in SFAS 5 does not require discounting, the above statement is generally consistent with other cited accounting literature, in that the determination of whether a loss has been incurred (recognition concept) is based on undiscounted cash flows, an approach precluded in FASB's impairment of a loan project. However, whether or not 5 to 7 years is a reasonable period of time and is an appropriate time frame for net realizable value, is not clearly determinable under existing GAAP. While we believe that 5 to 7 years is in excess of a "reasonably manageable future period," as discussed in FRR-28, the issue could and probably is argued when recognition and measurement of specific losses are considered. Unfortunately, neither FRR-28 nor other GAAP contains specific guidance to decide whether this loss recognition approach can be viewed as consistent with GAAP.

In addition to the questionable recognition test under the 1987 OCC guidance, there also appears to be an inconsistency with GAAP with regard to the measurement of loss for in substance foreclosed loans. The 1987 OCC loss measurement guidance requires that the excess of the loan balance over the undiscounted future cash flows be written off but also requires that reserves be established based upon the doubtful categorization of the difference between fair value and undiscounted cash flows. This treatment appears to be inconsistent with GAAP, which would require that the measurement of the loss for in substance foreclosures be based on the difference between the recorded loan balance and current fair value.

To demonstrate this inconsistency, assume that in the previous example the loan to Developer Y is being evaluated under the 1987 OCC guidance. In the last example presented above, the undiscounted future market value (including net annual cash flows) was $9.1 million. The loan amount was $10 million. Therefore, under the 1987 guidance, the "loss" classification amount would be $900,000. In addition, the difference between the

undiscounted future value ($9.1 million) and the current fair market value ($7.9 million) would normally be classified as "doubtful," with the balance of the loan passed or criticized as OEAM or Substandard, depending on the examiner's assessment of relevant credit factors. While it is conceivable that this doubtful category could be fully reserved and therefore be reserved in accordance with GAAP, it is more likely that this treatment would result in a reserve of some amount, say $600,000 (50 percent of doubtful) in addition to the loss amount written off. The total amount reserved or written off of $1.5 million compares to $2.1 million (from previous example) under GAAP. The ambiguities of GAAP and the OCC guidance make it difficult to assess whether either the 1985 OCC guidance or the 1987 supplemental guidance is in conflict with GAAP when total write-offs and reserves are considered.

In the above example, GAAP generally would require a larger loss than the total write-off and reserves required under the OCC 1987 guidelines, but not necessarily in all cases. The deciding factor is the treatment of the remaining loan balance, not classified as doubtful or loss. This treatment is left up to examiner judgment. However, the example utilizes a 36-month time frame as a "reasonable period of time." The 1987 OCC guidance would allow 5 to 7 years, in which case, under our earlier example, no loss recognition would be required.

The 1985 and 1987 OCC guidance in this area was rescinded March 20, 1992, when the OCC issued EC-234 (Rev) "Review and Classification of Commercial Real Estate Loans." EC-234 (Rev) incorporates into examination guidance the provisions of the interagency policy statement discussed below. With the issuance of EC-234 (Rev), the 5- to 7-year time frame and loss recognition concepts in EC-234 supplement No. 1 are revoked. The OCC has asserted that the temporary impairment provisions of EC-234 Supplement No. 1 were infrequently applied by examiners. However, no formal study of the impact of this circular in situations in which its concepts were applied was available.

The November 7, 1991, "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans" is the most recent regulatory guidance concerning loan losses. This policy statement provides guidance to examiners and management of depository institutions that may encourage optimistic future evaluations of real estate and thus inflated balance sheets.

The guidance suggests disregarding market prices in favor of discounted cash flow concepts using future projections that reflect anticipated recoveries in markets which are asserted to be cyclical. The following excerpts from the guidance illustrate the emphasis on estimated future values that may result in failure to recognize or adequately measure losses.

"Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property. Management should adjust any assumptions used by an appraiser in determining values that are overly optimistic or pessimistic."

"A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral. This analysis should not be based solely on the current performance of the collateral or similar properties; rather, it should take into account, on a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions."

"The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates."

"When estimating the value of income-producing real estate, discount rates and 'cap' rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, 'cap' rates, and income projections should not be used."

The use of the income approach (that is, discounted cash flow) in valuing troubled real estate is reinforced by attachment 2 to the Policy Statement, the "Valuation of Income Producing Real Estate." Examples which de-emphasize use of market data in developing valuations of properties are shown below:

"When adequate sales data are available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties are not sufficient to justify a conclusion."

"For unique properties or in markets that are thin or subject to disorderly or unusual conditions, market value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method for valuing the property."

"When an income property is experiencing financial difficulties due to general market conditions or due to its own characteristics, data on comparable property sales often are difficult to obtain. Troubled properties may be hard to market and normal financing arrangements may not be available. Moreover, forced and liquidation sales can dominate market activity. When the use of comparables is not feasible (which is often the case for commercial properties), the net present value of the most reasonable expectation of the property's income-producing capacity—not just in today's market but over time—offers the most appropriate method of valuation in the supervisory process."

"To the extent that current market activity is dominated by a limited number of transactions or liquidation sales, high 'capitalization' and discount rates implied by such transactions should not be used."

While the SEC in FRR-28 expressed its view that market data in an auction market for repossessed collateral (drilling rigs) was representative of value and must be used, the bank supervisory agencies do not appear to share this view.

Conclusions

We are encouraged by FASB initiatives in the impairment of a loan project to require earlier recognition of losses by recognizing and measuring such losses using present value concepts. However, FASB's proposed use of discounted cash flows would not reflect either market interest rates or use of current market prices in developing loan loss reserves. Fair value concepts are already reflected in existing accounting rules for problem loans. However, these concepts are constrained by identification of a foreclosure or an in substance foreclosure as the accounting event which results in use of fair values to measure losses. FASB's proposed standard would perpetuate many of the problems which arise in constraining the use of fair value concepts, and will not result in loan loss reserves which sufficiently reflect economic reality.

Our specific concern regarding the use of the probable definition to avoid loss recognition for nonperforming loans has been alleviated in the initial draft of the standards section of the Loan Impairment Exposure Draft

because all significant nonperforming loans should meet the definition of impairment. However, we continue to believe that a more likely than not criteria is more appropriate for use in recognizing loan losses for performing loans. Further, we believe that using fair value concepts as a starting point to recognize and measure loan losses rather than the probable criteria would result in more timely and reliable loan loss reserves. FASB's reiteration that probable does not mean virtually certain in the loan impairment project will not resolve our concerns that the probable threshold is ambiguously defined, and as implemented, unduly high. We believe that requiring loss recognition when the future event to confirm the loss is more likely than not to occur will result in more even-handed and consistent financial reporting.

Further, in situations where offers have been made and rejected or current market conditions can be inferred from other real estate transactions (even for noncomparable properties), we believe that such prices must be considered in the valuation process and, if rejected, documentation should be available that supports that conclusion. We are very concerned about the tone of the regulatory agencies' recent policy statement and the draft of the standards section of the Loan Impairment Exposure Draft which disregard market level interest rates and direct application of market based values. Further, the policy statement discourages inferring discount rates from transaction data in markets which are depressed. In so doing, the policy statement appears to be encouraging preparers of financial statements to assume they can hold property until some estimated future time when market conditions improve.

While some suggest that cycles in asset values exist, we discourage developing accounting standards premised on the assumption that a higher price for an asset will necessarily occur in the future. FASB's tentative decisions in the impairment of a loan project to not require reference to current market prices in measuring loan losses and to disregard market level interest rates in calculating present value and loan loss reserves may facilitate this inappropriate course of action by the federal regulators.

We believe that guidance is needed to clarify what constitutes a reasonable period of time that can be used to develop estimates of fair values when active markets do not exist. A period of time for lease up periods that reflect existing market indicators is acceptable.

Comments From FDIC, FRB, OCC, and OTS

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Office of Executive Director
Supervision and Resolutions

April 3, 1992

Mr. Donald H. Chapin
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Chapin:

Chairman Taylor has asked us to review and comment on your draft report entitled "Depository Institutions: Flexible Accounting Rules Lead to Inflated Financial Reports." We appreciate the opportunity to provide comments on the draft report's recommendations concerning problems you perceive in the accounting rules for loan losses.

Your report notes that the Financial Accounting Standards Board (FASB), the private sector body responsible for setting generally accepted accounting principles (GAAP), is working on a number of projects which will address loan impairment and improve accounting rules for the recognition and measurement of losses. In fact, the FDIC urged the FASB more than two years ago to resolve differences in the accounting rules applicable to different types of depository institutions such as those related to loan impairment. We are therefore encouraged that the FASB has undertaken a project that seeks to improve loan loss accounting. Nevertheless, you express concern that the FASB's project is not scheduled for completion until 1993 and will not be effective until the following year.

As a consequence, you recommend that, in implementing the accounting provisions of the FDIC Improvement Act during 1992, the federal banking agencies should make certain changes to the regulatory reporting requirements for loss recognition and measurement rules for loans. More specifically, you have recommended that the agencies' reporting rules should require that

(1) losses be recognized if they are more likely than not;

(2) current market prices must be considered in the evaluation process for nonperforming loans and, if rejected in favor of discounted cash flows, documentation to support that conclusion should be available; and

(3) reasonable periods of time reflecting lease-up periods and existing market conditions be defined and used to develop estimates of fair values when active markets do not exist.

See comment 1.

We do not believe that it would be appropriate for the federal banking agencies to change their loan loss recognition and measurement rules for depository institutions while the FASB is actively working to improve the accounting rules in this area. Rather, the FASB should be afforded the opportunity to proceed

with its project on loan impairment which will result in consistent standards applicable to all creditors. Interested parties, including the General Accounting Office, should make their views on this important subject known to the FASB.

See comment 1.

As we await the outcome of the FASB's work, our examination procedures will continue to recognize the importance of an adequate allowance for loan and lease losses and of loan review systems that enable institutions to promptly identify loans that warrant special attention because of collectibility concerns. Within the past year, we have provided additional guidance to examiners regarding the evaluation of the adequacy of the allowance for loan and lease losses, copies of which were also distributed to the banks under our supervision. Furthermore, our existing examination policies require examiners and institutions to consider the fair value of collateral when evaluating problem real estate loans and determining appropriate loss allowances. Under these policies, fair value estimates that are based on discounted future cash flows must be derived from supportable projections over reasonable time frames.

More detailed comments on the specific reporting changes recommended in your report are presented below.

Recognition of Losses

See comments 2 and 3.

As your draft report indicates, current generally accepted accounting principles require that an estimated loss from a loss contingency, such as the collectibility of receivables, must be charged to income if it is "probable" that future events will occur to confirm the loss and the amount of the loss can be "reasonably estimated." The relevant accounting standard states that "probable" means that the future events are likely to occur. However, because "probable" is too often being improperly interpreted in practice as "virtually certain" rather than "likely to occur," you are concerned that "probable" is too high a threshold to use in reviewing troubled loans for impairment and that it is ambiguously defined.

Your report observes that the FASB did not intend for "probable" to mean "virtually certain" and that the FASB has reiterated this in its draft of a loan impairment accounting standard. At this stage of its work on loan impairment, the FASB has also tentatively decided to retain the existing "probable" standard for loss recognition. Nevertheless, you believe that both the FASB and the federal banking agencies should change the "probable" criterion for loss recognition to a "more likely than not" (a more than 50 percent probability of loss) criterion.

We agree with the FASB that "probable" is not synonymous with "virtually certain." When our examiners evaluate the adequacy of an institution's allowance for loan and lease losses (ALLL), the conclusion they reach should be based on judgments regarding losses that are likely to occur, not merely those that are virtually certain. While this evaluation traditionally has been a significant element of the examination process, we are placing even greater emphasis on it today because of the impact that an inadequate ALLL has on an institution's capital. In those cases where our examiners conclude that an

institution's ALLL is not adequate, they have been directed to determine the estimated amount by which the ALLL needs to be increased.

See comments 2 and 3.

An inadequate ALLL is not a universal condition among the institutions we examine. Your report also acknowledges that not all accountants apply a "virtually certain" criterion for loan loss recognition and that this is an area that will always require substantial judgment regardless of the criterion that is used. As a consequence, we do not consider it appropriate for the federal banking agencies to change to a "more likely than not" criterion for loan loss recognition at this time. Such a change by the agencies would force a lower threshold for loss recognition onto all depository institutions, thereby penalizing those institutions that have promptly and properly recognized those loan losses that are likely to occur.

The FASB's standard-setting process will provide adequate opportunity for further discussion and consideration of what the threshold for loss recognition should be for all creditors. In the meantime, continued diligence on the part of examiners, in conjunction with the new annual examination requirement for insured institutions, should help to persuade those institutions that believe that losses must be "virtually certain" in order to be recognized (and their independent public accountants, if any) away from this improper understanding of the meaning for "probable."

Current Market Prices and Discounted Cash Flows

Under existing accounting literature, banks are not currently required to use discounting concepts when determining the appropriate loss allowance for a problem loan. On the other hand, thrift institutions are required to recognize interest as a holding cost when measuring loss allowances for problem real estate loans. At this stage of its loan impairment project, the FASB has tentatively concluded that discounted rather than undiscounted cash flows should be used to measure losses on loans.

Because you consider the recognition of the time value of money essential to the development of meaningful loan loss allowances, you support the direction in which the FASB's loan impairment project is moving. Nevertheless, for secured problem loans, you believe that greater emphasis should be placed on the use of fair value concepts to measure loan impairment. In other words, better loss estimates can be determined for such problem loans by using objective indicators of fair value from recent transactions in the marketplace than from subjective fair value estimates obtained by discounting expected future cash flows from these loans. In this regard, in the absence of available and reliable sources of repayment other than the loan collateral itself, you recommend that losses should be measured on problem collateralized loans using the fair value concepts applicable to the accounting for "in-substance" foreclosures.

As noted in your report, the accounting literature indicates that "fair value is the amount that the debtor could reasonably expect to receive in a current sale between a willing buyer and a willing seller other than in a forced or liquidation sale." The literature also states that the "fair value of assets

shall be measured by their market value if an active market for them exists. If no active market exists for the assets . . . but exists for similar assets, the selling price in that market may be helpful in estimating the[ir] fair value." Otherwise, discounted future "cash flows may aid in estimating the fair value of assets." In order for institutions to properly use transaction prices when estimating losses, your report indicates that the meaning of the term "active market" must be clarified. You note that clarification is needed because, at present, there are no specific guidelines for determining when an active market does not exist. You suggest that the definition of "active market" should exclude "fire sale" situations but that auction market transaction data are relevant to the determination of fair value.

See comment 4.

We agree that fair value estimates should be considered when measuring losses on problem collateralized loans such as troubled project-dependent commercial real estate loans. Our most recent expression of this long-held view is contained in the November 7, 1991 "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans." According to this policy statement, and in contrast to bank GAAP's silence on the need for discounting when measuring losses, when the repayment of a problem commercial real estate loan will be provided solely by the underlying real estate collateral, any portion of the loan balance in excess of the amount that is adequately secured by the value of the collateral is accorded a loss classification. When institutions determine the amount needed in the ALLL for problem commercial real estate loans, we believe that the methodology used by management should likewise consider the value of the underlying collateral. Of course, if management determines that the value of the collateral and other factors related to a loan indicate that the criteria for an "in-substance" foreclosure have been met, the loan should be accounted for accordingly.

Appraisals are professional judgments of the market value of real property. Examiners use the most recent appraisal (or internal evaluation) of the property securing a real estate loan to analyze the collateral's value and may make adjustments to this assessment of value when the facts and assumptions associated with this value are not reasonable. The management of each institution is also responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. The FDIC's real estate appraisal regulations require an appraisal to follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value. The appraisal must then reconcile these approaches and explain the elimination of each approach not used. The direct sales comparison approach examines the price of properties similar to the collateral property that have sold recently in the local market and estimates the value of the collateral based on the comparable properties' selling prices.

This approach appears to correspond to the second element of the measurement of fair value cited above which indicates that selling prices for similar assets for which there is an active market may be helpful in estimating the fair value of an asset for which there is no active market. Thus, when adequate sales data are available, the most weight should be given to the direct sales comparison approach when estimating the value of real property. However, commercial properties are not homogenous. Each property has its own unique

attributes and this may make data on comparable sales difficult to obtain. This condition becomes more pronounced when local markets and sales activity are depressed.

When market value estimates based on comparable sales are unavailable or distorted, we believe that the income approach is usually the appropriate method for valuing the collateral for a real estate loan. Because the income approach discounts future cash flows, it fits with the final element of the measurement of fair value that was cited previously. Nevertheless, as indicated above and consistent with your recommendation, when an appraiser renders a professional judgment on the value of real estate and eliminates the direct sales comparison approach in favor of the income approach, the appraiser must provide an explanation that supports this action. We would expect that such an explanation would demonstrate that there were not sufficient relevant sales data for comparable properties to justify a market value conclusion for the collateral property based on comparable sales. In other words, the appraiser would essentially need to show that there was not an active market for assets similar to the collateral.

Examiners evaluate the methodology and process that an institution's management follows in determining the amount that is needed in its ALLL in order to ensure that management has appropriately considered all of the relevant factors affecting the collectibility of the loan portfolio. These factors include the values that management estimates for the collateral underlying problem commercial real estate loans. As indicated above, these value estimates should reflect judgments as to whether there are active markets for these types of properties. If deficiencies are noted in management's process as it relates to the significance attached to estimated collateral values or to the reviews that are made of the estimates themselves, examiners are expected to criticize these deficiencies and seek appropriate changes.

See comment 5.

In this regard, to the extent that the meaning of the term "active market" needs clarification, we concur that the meaning should conform to GAAP and exclude forced and liquidation sales, i.e., "fire sales." However, we would caution against automatically considering the existence of auction market transactions in a local real estate market as evidence of an active market. Rather, careful scrutiny must be made of auction market transactions to distinguish between those that represent forced or liquidation sales and those that do not. Such scrutiny is necessary because we do not believe that it is appropriate to measure loan impairment on commercial real estate loans on the basis of liquidation values. While such values arguably could be used to determine one end of the range of possible loss on a problem commercial real estate loan, for a going concern that does not intend to force the liquidation of collateral, a loss amount based on liquidation values does not seem to us to represent a better estimate of loss than any other amount within the range of possible loss.

Use of Reasonable Periods of Time When Estimating Fair Values

Your report's discussion of the status of the FASB's loan impairment project and the tentative decisions that have been made by that body reveals that you

are concerned that the FASB has to date not provided sufficient guidance on how estimates of future cash flows and market interest rates are to be derived. More specifically, you believe that the FASB should address the meaning of "foreseeable future" and the role of current conditions as they both relate to the future cash flows that are used to estimate fair value when active markets do not exist. Although the Securities and Exchange Commission has described "foreseeable future" as a reasonably manageable future period in which cash flow assumptions for the property are expected to be attainable, you do not consider this to be adequate guidance. You suggest that an acceptable time period to use would be a lease-up period that reflects current market conditions unless clear evidence exists that supports estimates of changed conditions. In any case, you believe that such a period should be less than five to seven years. As discussed below, we agree that five to seven years is too long a period of time in virtually all cases.

See comment 6.

Estimating a property's future cash flows for purposes of determining its fair value using discounting concepts requires considerable judgment. Last year's interagency policy statement on commercial real estate loans indicates that estimates of a property's value should be based on reasonable and supportable projections of rents or sales, expenses, and occupancy rates. This typically means that the time frame over which cash flows should be estimated is the length of time until a normal occupancy and rent level is expected to be achieved. This time frame can vary from market to market, from period to period, and for different types of commercial properties. Accordingly, it would be inappropriate to set an arbitrary time frame such as two years as the definition for "foreseeable future."

While no maximum time frame for attaining such a stabilized condition is specified in the interagency policy statement, your report asserts that the regulators consider five to seven year time frames acceptable. You refer to the policy guidance for troubled real estate loans that was issued by the Office of the Comptroller of the Currency in 1987 which mentions the five to seven year time frame. However, the FDIC has not issued comparable guidance and, in most circumstances, we would consider a five to seven year time period to be longer than the time frame for which reasonable and supportable estimates of future cash flows can be made. While there may be situations in which stabilized occupancy and rental rates for a property are not reasonably expected to be achieved within such a time frame, when estimating the property's value in such a case we would consider it inappropriate to use a holding period which exceeds the time frame for which reasonable and supportable cash flow projections can be made.

Thank you for affording us the opportunity to review and comment on your draft report. Should you wish to further discuss our comments, please feel free to contact us.

Sincerely,

Paul G. Fritts
Executive Director

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

April 7, 1992

DAVID W. MULLINS, JR.
VICE CHAIRMAN

Mr. Donald H. Chapin
Assistant Comptroller General
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Chapin:

I am writing to respond to your letter of March 18, 1992, in which you requested comments on the General Accounting Office's draft report on problems with accounting standards for loan losses. We welcome this opportunity to comment and would begin by saying the report provides a useful analysis of the accounting standards used to recognize and measure loan losses. We do, however, have different views on some aspects of the report, which are indicated in the discussion below.

The report concludes that the degree of flexibility and management discretion permitted by the current accounting literature respecting the timely recognition of loan losses has contributed to inaccurate reporting by failing depository institutions. Thus, the report urges the federal depository supervisory agencies, consistent with their responsibilities for reviewing accounting standards under the FDIC Improvement Act, to issue further regulatory guidance in this area. To that end, the report specifically recommends that:

- Loan loss provisions be recognized when they are "more likely than not", rather than "probable" as specified by current generally accepted accounting principles (GAAP).

- Current market prices must be considered in the evaluation process for nonperforming loans and, if rejected in favor of discounted cash flows, documentation to support that conclusion should be available.

- Reasonable periods of time reflecting lease-up periods and existing market conditions be defined and used to develop estimates of fair values when active markets do not exist.

With respect to the first recommendation, the Federal

See comment 7.

Reserve recognizes that more specific guidance in assessing the reliability of loan loss reserves would be desirable, so long as sufficient flexibility could be preserved to accommodate all relevant factors affecting the realization of losses and the legitimate differences that exist among banking organizations. Providing better clarity regarding when losses should be recognized moves in this direction. However, it is important to emphasize that, ultimately, it is impractical to remove all judgment and management discretion from the reserving process.

See comment 2.

The primary objective of the reserving process is to establish a level of reserves that is adequate to cover future charge-offs. We believe an overemphasis on phraseology, such as "probable" and "more likely than not", can create a danger of losing sight of this objective. Moreover, it is not clear that changing from a "probable" loss specification to a "more likely than not" specification would add greater precision to the reserving process.

See comment 7.

To accomplish the objective of establishing reserves that will prove adequate to cover anticipated loan losses, institutions should apply a methodology which ensures that all significant factors that can affect the collectability of the loan portfolio are given appropriate consideration. Such a methodology, by necessity, must allow some management discretion to exercise judgement in developing estimates of losses, because there are many factors unique to each depository institution that can affect the timing and the amount of losses to be experienced by the institution.

See comment 8.

At the same time, there exists the possibility that by according such discretion, in some cases at least, institutions will not reserve adequately. Thus, there is a need that appropriate discipline be imposed on the reserving process of each organization.

Providing that discipline is in part the responsibility of the accounting profession. In addition, the supervisory agencies have a key role to play in promoting integrity in the reserving process. The supervisory agencies, for example, have established separate regulatory reporting standards and examination guidance which instruct institutions to review the adequacy of their loan loss reserves at least quarterly and to maintain loan loss reserves at levels adequate to absorb anticipated losses. The on-site examination process also contributes importantly in promoting discipline in the reserving process. It is the job of examiners to review whether management has used reasonable judgment and relied on accurate information in establishing reserves that are adequate to cover loan losses.

While the overall supervisory framework generally appears to have worked reasonably well in the case of most institutions, the Federal Reserve recognizes that, as with any system pertaining to complex issues, there is room for improvement in the existing procedures for establishing and assessing reserves. Accordingly, the Federal Reserve is currently working with the other regulatory agencies to explore ways to develop more structured and consistent operational guidance for bankers to follow in determining their reserve needs and for examiners to use in assessing whether an institution's reserving policies and practices are leading to adequate reserve coverage.

With regard to GAO's second recommendation, we recognize that consideration should be given to current market prices in assessing an institution's reserve needs; however, this should not be the only factor considered. We further agree that, if a decision is made to base the valuation of an asset on other considerations as well, including the discounted value of future cash flows, that decision should be adequately explained in the institution's documentation.

See comment 9.

In considering the extent to which reference should be made to market prices in the evaluation process, it is important to take a number of points into account. First, in many cases the market for certain assets can be so thin that implicit bid-ask spreads are relatively wide. Moreover, during periods of market instability, the spreads can widen still further reflecting the infrequency of transactions and general instability in the market. Active, well-functioning markets simply do not exist for many assets, and as a result, market values in such thin markets are generally not economically meaningful.

In addition, it is important to point out that one of the principal strategies of commercial banks is to use credit insights to make and hold loans that are inherently illiquid. Thus, in general, looking to the current liquidation value of commercial loans would not be an appropriate means for measuring the success or failure of such a business strategy. It is, of course, the case that the potential repayment prospects of a loan can change and this should properly be reflected in the loan loss reserve.

It is also important to recognize that the value of an asset to a particular institution can be substantially different from its liquidation value, especially if that asset would be sold into an unstable or illiquid market. For example, in some cases one institution's information base, built up over time, may enable it to assess the value of an asset more accurately than less well-informed investors. In addition, some institutions may have specialized skills for managing a particular type of asset,

enabling them to realize greater value from owning the asset relative to less efficient managers. Thus, focusing unduly on liquidation values can substantially understate the true economic value of assets to an institution.

See comment 4.

It was in light of such considerations that the November 7th policy statement clarifying regulatory treatment of commercial real estate loans emphasized the need for a balanced approach in assessing credits, one that looked beyond the immediate liquidation value of underlying collateral. Examiners were instructed to consider, in addition to current market values, other important factors, including the character, overall financial condition and payment record of the borrower, the prospects for support from any guarantors, and the nature and degree of protection provided by the cash flow and value of the underlying collateral. By focusing on all of these factors, the policy is intended to safeguard the deposit insurance fund while, at the same time, not inadvertently curtailing the availability of credit to sound borrowers.

See comment 10.

We find ourselves in general agreement with the GAO's third recommendation. It is, indeed, appropriate, when assessing the fair market values of assets where active markets do not exist, to make reasonable assumptions as to lease-up periods and to take existing market conditions into account. In assessing the implications of existing market conditions, of course, it is necessary to consider the state of the market. For example, it may not be appropriate to assume that a market which has recently experienced a sharp decline in values will reverse course in the near term future, but it might be appropriate to conclude that with the passage of time it will develop more stability.

It is, moreover, important to distinguish between the outlook for the general market and that for individual loans and properties. For example, it is reasonable to project that a commercial property, that is only 10 percent leased-up in a market in which most commercial properties have considerably higher occupancy rates, will be able to attract additional tenants, in part, from the other properties.

See comment 11.

In conclusion, we are aware that there have been situations in which an institution had at the time of its failure loss reserves that fell far short of the losses incurred by the FDIC and the RTC in liquidating its assets. In part, this has occurred because these agencies have been faced, at times, with the challenge of selling assets into unstable, distressed markets. In addition, in many situations market conditions have continued to deteriorate after the depository institution has failed, thus augmenting the problems in a failed institution's asset portfolio. But, we also recognize that, even after full allowance is given for these important factors, it may well be the case that the reserves of some institutions were inadequate

to cover a reasonable projection of loan losses. For this reason, as I mentioned earlier, the Federal Reserve has joined with the other agencies to consider ways to strengthen the standards and methodology used by institutions for reserving and those used by examiners to evaluate that activity.

We appreciate the opportunity to comment on your draft report and the recommendations it contains.

Sincerely,

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

April 6, 1992

Mr. Donald H. Chapin
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Chapin:

I am responding to your letter of March 18, 1992, to Stephen R. Steinbrink, Acting Comptroller of the Currency, requesting comments on recommendations you plan to make to the banking regulators regarding changes to the way that banks recognize and measure loan losses.

We share the GAO's interest that banks accurately report the carrying value of their assets, including nonperforming loans and loans that are classified as problems. It is particularly important that banks recognize loan losses and make adequate provisions for potential losses in their portfolios.

See comment 12.

However, we believe that the GAO draft report makes recommendations that are neither justified by solid evidence nor well-suited to overcome the problems inherent in the judgmental nature of loan loss reserving. The report is incorrect because it uses FDIC estimates of the value of assets of failed banks as the basis for arguing that banks are failing to set aside adequate loan loss reserves. FDIC estimates reflect numerous factors that are not relevant to a bank that is a going concern.

FDIC loss estimates include other costs besides loan losses; even a good loan sold by the FDIC from a failed bank is often worth less than its value in a going-concern bank. That is one reason FDIC is making a greater effort to keep the assets of failed and failing banks in the private sector rather than in the hands of FDIC liquidators.

Moreover, in many cases, FDIC loss estimates have proved to be wrong. For example, the FDIC substantially overestimated the cost of resolving the 1991 failures of the three banks owned

by Bank of New England. At the time of the failures, the FDIC estimated resolution costs at $2.492 billion, about 11 percent of the failed banks' assets. The FDIC's most recent estimate of resolution costs for BNE is $1.035 billion, less than half the original amount.

The OCC is concerned that some banks might misapply Generally Accepted Accounting Principles (GAAP) for loan loss reserves. GAAP in this area are based on broad standards established by the Financial Accounting Standards Board (FASB) for the recognition of loss contingencies. As the GAO report notes, even the American Institute of Certified Public Accountants (AICPA) has given conflicting interpretations of how these broad standards should be applied in its Audit Guides for different financial service industries.

Separately and with the other federal bank regulators, we have continually worked to refine the standards for establishing the Allowance for Loan and Lease Losses (ALLL). For example, we recently issued a revised banking circular on the ALLL to provide clearer guidance to banks on timely identification and recognition of inherent loan losses. We are currently working with the other bank regulators to ensure that we all follow a consistent approach on the ALLL and, where possible, provide further guidance to banks and bank examiners on determining an adequate ALLL.

A related effort was the interagency statement on the review and classification of commercial real estate loans (November 7, 1991). In addition to providing classification guidance, the policy statement detailed additional factors that banks should consider in assessing the adequacy of the ALLL as real estate loans become increasingly dependent on collateral for repayment. When the effects of these efforts are combined with the higher levels of capital under the risk-based capital guidelines and the increased supervision resulting from annual examinations, we believe the exposure of the FDIC to loss is significantly reduced.

We are always interested in suggestions for improving the accuracy of our reporting standards. However, we do not believe that the GAO report gives appropriate credit for the improvements brought about in the November 7th release, but rather is based on a misinterpretation of that release. We also do not believe that the report's recommendations will achieve improved reporting or a more accurate reflection of actual losses in a bank's portfolio.

For example, we are not convinced that introducing a new qualitative term, such as "more likely than not" to replace "probable," will lessen the degree of judgment inherent in the evaluation of the ALLL. The attached technical appendix details our specific concerns about the report's recommendations.

We appreciate the opportunity to comment on your draft report. I would be pleased to discuss the report further or provide any information that would be useful to you in your review of this important issue.

Sincerely,

Susan F. Krause

Susan F. Krause
Senior Deputy Comptroller for
Bank Supervision Policy

Attachment

OCC RESPONSE TO DRAFT GAO REPORT ENTITLED,

"DEPOSITORY INSTITUTIONS: FLEXIBLE ACCOUNTING RULES LEAD TO INFLATED FINANCIAL REPORTS"

APPENDIX

The GAO report recommends that, as a more timely alternative to the ongoing project of the Financial Accounting Standards Board (FASB) on loan impairment, the federal banking and thrift regulatory agencies develop new rules for loan loss recognition and measurement in the preparation of regulatory reports.

Specifically, GAO believes that the agencies should require that:

- losses be recognized if they are more likely than not;
- current market prices must be considered in the evaluation process for nonperforming loans and, if rejected in favor of discounted cash flows, documentation to support that conclusion should be available;
- reasonable periods of time reflecting lease up periods and existing market conditions be defined and used to develop estimates of fair values when markets do not exist.

We strongly recommend that the GAO reconsider issuing these recommendations. We disagree with key conclusions reached in the report and believe that the recommendations are, in part, unclear. Our conclusion is based on the following key factors:

See comment 13.

- We believe that the report's comparison of reserves at banks that are going concerns with reserves at institutions in FDIC control is incorrect. Using this standard, we could be required to close banks that are still solvent.

See comment 2.

- We do not believe that a "more likely than not" standard will be more precise or objective than the existing "probable." Instead, the ongoing initiatives of the agencies are requiring a greater focus on the entire reserving process. We view this as a priority.

See comment 14.

- The report mistakenly asserts that the agencies promote the use of discounted cash flows as alternatives to existing representative market transactions in valuing collateral. The report also incorrectly implies that the roles of market values and discounted cash flows are mutually exclusive.

See comment 6.

- We do not agree that the establishment of standards for the variables involved in estimating real estate values will ensure fair presentation of a bank's financial position.

See comments 4 and 15.

- o The report is unclear as to when it would require the use of market values of collateral in loan loss evaluations. If the scope extends only to loans with an indication of collateral dependency, the guidance recommended has already been prescribed in the interagency release of November 7, 1991, on the review and classification of commercial real estate loans (the November 7th release).

  However, if the intent is to apply the recommendation to all nonperforming loans, such a broad use of market values prior to resolution of the issue of whether market value accounting will replace the existing historical cost based model is premature and may hinder the development of a consistent, comprehensive accounting model for all financial instruments.

- o The report does not adequately consider the changing role of capital as it relates to the reserve for loan losses.

See comment 1.

These concerns and several others are further discussed below. We share the GAO's objectives regarding the safety and soundness of the country's financial institutions. However, we believe these objectives are better served by completion of the ongoing initiatives of the federal financial institutions regulatory agencies. Included in those initiatives are efforts to provide greater guidance to banks and thrifts on factors they must consider in evaluating the adequacy of the allowance for loan and lease losses (the "Allowance"). At the same time, the OCC will continue to monitor the FASB's standard setting process and present our views in the comment process.

<u>Use of FDIC valuations as indicators of inadequate reserves:</u>

We disagree with the GAO's assertion that the FDIC valuations of assets after an institution has failed demonstrates that bank loan loss reserves are inadequate.

See comments 12 and 13.

First, the FDIC's valuation of such assets does not reflect an important accounting concept: the concept of going concern. Inevitably, certain assets in the hands of the FDIC are valued on a basis which is significantly different from what a going concern bank would likely collect on a specific loan.

For its purposes, the FDIC is properly computing reserves. However, the values at which the FDIC will dispose of assets are not indicative of market values as that term is defined in accounting for a going concern, for several reasons.

First, market value contemplates a fair current sale between a willing buyer and a willing seller. Second, market behavior shows that when a bank's assets are disposed of by, for example, a receiver, even previously performing loans are less likely to be fully realized. Also, it is generally believed that the market typically requires a greater discount when the seller is the government. Accordingly, we believe there is no basis for comparing the FDIC reserve amount with a reasonable loan loss reserve for a bank that is a going concern.

Losses that are "more likely than not":

See comment 2.

The GAO report indicates that the FASB's Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies", (FAS #5) requirement that losses be "probable" before they are recognized is too often being improperly interpreted as "virtually certain." GAO has recommended that the federal banking agencies require that losses be recognized if they are "more likely than not."

We share the GAO's objective of ensuring that banks recognize losses on problem loans in a timely manner. However, we also share the view of the FASB that the "probable" standard in FAS #5 is an appropriate criterion for provisions to a valuation reserve. We do not believe that misinterpretation of the "probable" standard by some banks can be remedied, as the report suggests, by changing the standard for all banks. Nor do we see any reason to believe that a "more likely than not" standard for reserving will be more precisely or objectively applied than the existing "probable" standard.

In our view, timely recognition of losses on problem loans is better achieved by requiring that banks maintain an effective loan review system that will identify asset quality problems in an accurate and timely manner and result in timely provisions for loan losses.

See comment 16.

To achieve this goal, a number of steps are being taken. First, the OCC has recently clarified and reinforced its guidance to national banks on the recognition of losses through a revision to Banking Circular 201 on the Allowance. Second, the OCC is participating in a joint agency initiative to provide banks and bank examiners with more definitive guidance for making provisions for loan losses. Finally, we are substantially increasing our examination staff so that we can better monitor the effectiveness of banks' loan review systems and the adequacy of reserves through more frequent examinations.

See comment 1.

As a practical matter, the application of any standard for loss recognition is a highly judgmental process. As such, the examination process will always play an important role in ensuring banks appropriately reserve for loan losses. The revised banking circular requires that national banks maintain an

Allowance that is adequate to absorb all estimated inherent losses in the bank's loan and lease portfolio. The circular also reminds banks that an effective loan review system is an essential part of the process of determining an adequate level for the Allowance.

In evaluating the adequacy of the Allowance to absorb those losses, the OCC expects national banks to consider all outstanding loans, leases, and binding commitments to lend, regardless of whether they are currently considered to be a problem. For significant problem credits, including, at a minimum, all credits classified doubtful, the OCC expects national banks to perform an individual analysis of each credit and make an allocation of the Allowance that is sufficient to cover the inherent loss that probably exists based on the facts and circumstances as of the evaluation date.

See comments 3 and 17.

In practice, we believe the doubtful classification encompasses substantially all loans on which at least some loss is believed to be "more likely than not." However, national banks must also ensure that the Allowance is adequate to cover unrecognized inherent losses that exist in the rest of the portfolio, including less severely classified loans and uncriticized loans. While it is usually not practical to identify the inherent loss on all loans on an individual loan basis, banks typically provide for these credits as part of a pool or pools of loans, based on historical loss experience, adjusted for changes in trends and current conditions.

Finally, the FDIC Improvement Act of 1991 (FDICIA) requirement for prompt corrective action -- including closure in many circumstances -- when a bank becomes critically undercapitalized, underscores the need for banks to neither overstate nor understate the level of losses in their loan portfolios.

<u>The use of discounted cash flows in valuing real estate:</u>

See comment 5.

We agree with the GAO report's assertion that a value based on representative market transactions between willing buyers and sellers should typically be considered the best indication of value. In the November 7th release we make it clear that banks are required to use comparable market values when they are available. Generally, discounted cash flows should be used when market transactions for the asset in question or similar assets are not available to provide reliable indications of value.

As the GAO report notes, in many real estate markets today there is a distinct lack of representative market transactions to aid in the valuation of collateral underlying real estate loans or real estate held as other real estate owned (OREO). Sales that have occurred often do not provide adequate comparables because they are distressed sales that lack a willing seller.

However, the GAO report should consider that generally accepted appraisal standards impose requirements on the use of data concerning market transactions and discounted cash flows in the valuation process. These requirements are codified in the Uniform Standards of the Professional Appraisal Practice, as developed by the Appraisal Standards Board of The Appraisal Foundation (the "uniform appraisal standards"). The OCC expects banks to follow these standards in the valuation of real property.

See comment 18.

These uniform appraisal standards explicitly require appraisers to "collect, verify, analyze and reconcile" comparable data relative to the property being appraised under the three approaches used to determine value. These three approaches, commonly referred to as the cost approach, market or comparable sales approach, and income approach (which uses discounted cash flows), are distinct but not mutually exclusive in determining a collateral's value. Rather, data accumulated under each approach is analyzed to arrive at the best determination of value. The OCC requires that the bank must maintain documentation for any reasons that data derived under each method is excluded or weighted in the evaluation.

<u>Definition of standard variables to be used in estimating fair values in inactive markets:</u>

The GAO report states that the FASB project does not appear to be heading in the direction of providing sufficient guidance on how key estimates in the valuation process should be made. The report suggests that the bank regulatory agencies should establish standards for these estimates.

See comment 6.

During the development of the November 7th release on real estate loans, the agencies considered the techniques used in the industry in the valuation of collateral dependent real estate loans. One of the objectives of the agencies was the possibility of establishing standards that could be used for appraisal assumptions on lease-up periods, growth of market rents, limitations on "foreseeable future", etc.

After study, the agencies saw several obstacles to be overcome in establishing such standards. First, the variables in question will differ widely from property to property and market to market. Depending on the degree of market disequilibrium that exists, these factors can fluctuate significantly. At best, any standards would be arbitrary relative to the great majority of properties.

Second, there is a great risk that even "guidelines" established in these types of situations can become hard and fast standards. While on the face this may seem attractive from a safety and soundness standpoint, it can backfire. If these standards are set so rigidly that few will violate them, they will likely suppress proper accounting and reporting in a great many

situations. If they are initially set as a middle ground, they invariably leave the door open for as many potential violations as they prevent.

Also, the establishment of standards would put the agencies at odds with the Uniform Standards of Professional Appraisal Practice. Given that banks and thrifts rely heavily on appraisals performed under such uniform standards, there would be many problems created by the agencies' action.

Accordingly, in the development of the November 7th release, the agencies decided that the best course was to provide detailed guidance to support an informed exercise of judgment by bankers and examiners.

Use of market values in evaluating loan losses:

See comment 19.

The GAO report is unclear as to the circumstances under which it would require the use of market values in establishing loan loss Allowances. In Appendix I, the report states that even if a loan is nonperforming, "other borrower funding for the loan and guarantees should be considered and a loss need not necessarily be recognized for collateral shortfalls."

However, elsewhere in Appendix I, the report expresses concerns that the FASB project "does not call for the recognition of the fair value of all nonperforming loans." The report recommends that the agencies require that market prices be considered in the evaluation of "nonperforming loans."

If the report recommends that market values play a role only when repayment will not likely come from sources other than the collateral, we believe the recommendation may not be necessary. We believe that the OCC and the other agencies have already taken steps that adequately address this recommendation. The November 7th release clearly describes the situations in which the market value of a loan's collateral should impact the loan loss estimation process.

See comment 20.

We agree with the report's observation that in many cases, the use of undiscounted cash flows in assessing loan losses does not reflect economic reality. The AICPA Bank Audit Guide is commonly interpreted to allow loan loss recognition to be based on undiscounted cash flows. However, for collateral dependent loans, industry practice has evolved to the point where it is seldom used that way. And, as the GAO report notes, the preliminary conclusions of the FASB project on loan impairment indicate that industry practice in this regard will likely be ratified.

See comment 21.

Further, the OCC document cited in the report as allowing the use of undiscounted cash flows in certain loss recognition assessments (Examining Circular 234, Supplement #1), has been superceded by the November 7th release of the agencies.

The OCC document was superceded for two principal reasons. First, the November 7th guidelines are a more comprehensive approach to the measurement of impairment in collateralized loans. These guidelines incorporate the same principle of assessing the earnings capacity of a real estate property over time, but on a discounted basis. Second, an internal OCC review indicated that Supplement #1 to EC 234 was seldom used because the concepts expressed in the document could be objectively supported for few loans and because of the evolution of industry practice, as described above.

In the November 7th release, the agencies considered the question of when the market value of the collateral underlying a loan became an overriding factor in loan loss evaluation. The agencies concluded that, as the November release states, "...as other sources of repayment for a troubled collateralized loan become inadequate over time, the importance of the collateral's value in the analysis of the loan necessarily increases." Thus, as it becomes more likely that realization of the loan is dependent on the collateral, market value takes on a greater role in the determination of carrying value.

Total dependence on collateral for repayment, such as OREO or insubstance foreclosure would require carrying the asset at the lower of cost or market. Until that time, market realization should be weighed against the likelihood of realization in due course, i.e., from the borrower, guarantors, or other sources. The closer to one extreme, the greater the emphasis on market value, the closer to the other, the less market value should be a consideration. We view this as a matter of judgment for banks and examiners.

See comment 19.

However, if the report intends to recommend that market values of collateral be used in establishing reserves for all nonperforming loans, regardless of alternative repayment sources, we strongly disagree. We believe the broader issue of whether market values should be the basis for accounting for banks and thrifts must be determined before such a use of market values is considered.

The GAO report states generally that when a loan becomes nonperforming "creditors look to the collateral securing the loan to satisfy the debt." This statement does not recognize that while nonperformance may be an indicator of risk of default, it is not always an indicator of risk of loss. Many nonperforming loans will be substantially, if not fully, repaid without the liquidation of the collateral. In such cases, market value of the collateral is not relevant in assessing the carrying value of these loans.

It first should be decided whether the historical cost accounting model will be abandoned. If it is not abandoned, the approach recommended by the GAO report would establish carrying values for many loans that do not reflect the likely realization of those loans. This could cause a further loss of credibility and consistency in reporting by banks and thrifts.

See comment 22.

The role of capital:

We also believe that the changing role of capital cannot be overlooked in any initiative to modify the Allowance estimation process. The Allowance is not included in core capital, so the adequacy of each should be considered in assessing the buffer to the insurance fund. Capital protects against unexpected future losses, the types of losses which a bank should not provide for in its Allowance as a going concern.

At the end of 1992, the Basle standards will be in full effect. Also, the recent banking legislation, FDICIA, requires the establishment of capital zones for such risks as loan concentrations and interest rates, among others.

Finally, FDICIA requires that prompt corrective action be taken to close banks when certain minimum capital standards are violated. The GAO report correctly notes that the effectiveness of these "tripwire" provisions will be limited if the Allowance is inadequate.

But, there will be equally serious consequences if excessively conservative estimates of future loan losses are forced through the Allowance. Such provisions will erode core capital, forcing the required prompt corrective action. Losses not expected for a going concern, but possible under a liquidation scenario, should instead be protected by core capital without a charge to earnings. In this way, some institutions that would have been improperly closed would remain viable and prevent insurance fund losses.

The FASB projects:

The objective of FASB's effort with respect to loan impairment is to bring consistency to an area of accounting that has been the subject of varying practices. As you are well aware, accounting policies and practices have varied not only between financial services industries, but among institutions within the same industry, as well.

We believe that the comprehensive approach being taken by the FASB in dealing with the question of loan impairment measurement and recognition, as part of its broader project on accounting for financial instruments, is crucial. By integrating the loan impairment project into the effort on financial instruments, the FASB is also attempting to develop consistent accounting principles for financial instruments that are similar in substance, though different in form.

The FASB project has included an exhaustive study of many complicated issues. But, as the GAO report correctly notes, certain issues regarding the implementation of the loan impairment project require further study. We intend to raise

these and other issues with the FASB in the exposure draft comment process and any other forum made available to us. We believe that the GAO should re-direct its recommendations to the FASB as part of the public comment process, as well.

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6590

Jonathan L. Fiechter
Deputy Director
Washington Operations

April 6, 1992

Mr. Donald H. Chapin
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Chapin:

I am responding to your request for comments on the draft General Accounting Office ("GAO") report, "Depository Institutions - Flexible Accounting Rules Lead to Inflated Financial Reports."

OTS agrees that the GAAP accounting rules applicable to problem loans and investments are ambiguous, and, in application, resulted in delayed recognition of losses during much of the 1980s. The GAO report makes a valid case that the use of undiscounted cash flow measures allows banks to ignore market realities when estimating losses. However, OTS recognizes that the failure of GAAP to recognize losses in a timely manner involved more factors than just the discounting issue. The thrift industry used discounting in the 1980s, but thrift financial statements did not always recognize losses in a timely manner. As a result, thrifts that were insolvent on a GAAP basis caused even larger losses in liquidation.

Regulators observed in the 1980s that some accountants believed that a loss on a loan or investment had to be "virtually certain" before a loss was recognized under GAAP. The accounting standards and the "probable loss" criteria did not (and may still not) adequately provide for risk of loss from poor quality loans and investments. GAAP does not require loss provisions to provide for the risk of loss from troubled loans and investments, nor for the return the marketplace would demand to assume comparable risk. As a result, the equity and operating results reported by thrifts in accordance with GAAP may not track with the "true financial condition" of the thrift.

OTS has worked to address these deficiencies by using asset classification as the basis for loss provisions. In general, the asset classification process evaluates the quality of assets and the resulting loss provision provides for the risk of loss from identified poor quality loans and investments. It is our observation over the last two years that OTS asset classification practices are a major determinant in accounting for loss provisions in financial statements.

OTS has also used asset classification to identify troubled institutions. As classified assets and deficiencies in underwriting practices and in management are identified, OTS requires a larger loss provision for the risk of loss.

GAO Recommendations:

1. The GAO recommends that losses be recognized if they are "more likely than not."

See comment 23.

As part of its analysis of the adequacy of loss allowances, OTS classifies assets according to their risk of loss. Loans classified "substandard" or "doubtful" have weaknesses that subject the thrift to some risk of loss. A loss provision is provided based on probable loss, given an assessment of numerous risk factors. OTS believes that the resulting loss provisions provide adequately for the identified risk of loss.

See comment 24.

Often, some portion of a loan with significant weakness (such as those that are troubled or non-performing) is classified as "loss." When the supportable income-producing capacity of the collateral cannot service the loan and there is no other source of repayment, the loan balance in excess of the collateral's fair value may be a reasonable estimate of loss. Experience suggests that in such cases when the collateral is the ultimate source of repayment, there is a loss. The OTS believes that it is not reasonable to provide a 100% loss provision based on fair value when the supportable income-producing capacity of the collateral can service the loan.

2. The GAO recommends that "current market prices must be considered in the evaluation process for non-performing loans and, if rejected in favor of discounted cash flows, documentation to support that conclusion should be available."

The OTS agrees. Loans, in general, are made (and evaluated by institutions and examiners) based on the borrower's willingness and capacity to repay under the loan terms.

Further, for income-producing properties, an evaluation of the income-producing capacity of the collateral should be considered. Thus, OTS looks at the character, overall financial condition, resources, and payment record of the borrower, the prospects for support from financially-responsible guarantors, and the protection provided by the cash flow and value of the underlying collateral or business.

See comment 19.

As stated in the November 7, 1991, Interagency Policy Statement, as a loan becomes troubled or non-performing, the importance of the collateral's value or the fair value of the loan in the analysis increases. This does not mean, however, that all troubled or non-performing loans must be evaluated solely on collateral value. For example, when there is a financially-responsible guarantor, reliance solely on collateral value is likely to misrepresent the likelihood of loss.

See comment 5.

We agree that current market prices are the best indicator of the loan value under certain conditions (and assuming a reasonable marketing period and adequate liquidity for financing transitions). For example, they are a good indicator when comparable sales data are available. An active auction market is a reasonable indicator of fair value under normal circumstances. OTS does not believe, however, that foreclosure sales represent an active market. When comparable sales data is not available (for example, foreclosure sales may dominate market activity), the net present value of supportable expectations of the property's income-producing capacity consistent with appraisal standards offers the most appropriate method of valuation. Regardless of the valuation method used, OTS agrees that the methodology and assumptions should be fully supported.

3. The GAO recommends that "reasonable periods of time reflecting lease-up periods and existing market conditions be defined and used to develop estimates of fair values when active markets do not exist."

OTS is concerned about the use of overly optimistic or pessimistic cash flow assumptions that ignore active markets and judgments required in making assumptions about future markets. OTS relies on appraisals and appraisal standards utilized by licensed appraisers to help support assumptions. Lease-up periods and other assumptions used in fair value estimates should be supportable. They should not be overly optimistic or pessimistic; they should be realistic. Because of the unique characteristics of each property and market, and the fact that the cash flows are discounted at a market

See comment 6.

rate (which reduces the benefit of extended holding periods), lease-up periods should not be arbitrarily limited. In addition, arbitrary limits may not be consistent with appraisal standards.

I would be pleased to discuss these comments with you.

Sincerely,

for Jonathan L. Fiechter

The following are GAO's comments on the Federal Deposit Insurance Corporation letter dated April 3, 1992; the Board of Governors of the Federal Reserve System letter dated April 7, 1992; the Office of the Comptroller of the Currency letter dated April 6, 1992; and the Office of Thrift Supervision letter dated April 6, 1992.

GAO Comments

1. The current direction and timing of FASB's project indicates that it will not provide an appropriate solution to our concerns and existing accounting rules for loan losses continue to distort the true financial condition of financial institutions. There is an urgent need to obtain more reliable financial data to support the regulatory process and to minimize losses to investors, the insurance funds, and, ultimately, the taxpayers. The FDIC Improvement Act mandates and expresses the Congress' intent that deficiencies in existing accounting rules be addressed on a timely basis by the regulators.

2. Implementing either the existing probable criteria or our suggested more likely than not criteria entails the use of judgment. The judgments necessary in implementing the more likely than not criteria are limited to determining whether the probability that an event will confirm that a loss existed as of the reporting date has a more than 50 percent probability. Implementing the probable criteria requires judgments not only of the probability of loss, but also as to what the ambiguously defined probable criteria means. The lack of a firm benchmark for the probable criteria causes the more likely than not criteria to be inherently less judgmental in application.

3. We do not agree that requiring banks to reflect losses which are more likely than not to have been incurred penalizes institutions any more than reflecting economic reality ever truly penalizes institutions. We note also that the Office of the Comptroller of the Currency stated in its comments that, in practice, the doubtful classification encompasses substantially all loans on which at least some loss is believed to be more likely than not. OCC also uses a classification system as a tool in assessing the adequacy of the allowance for loan losses. The disparate views of the regulators on this issue illustrate our concern that ambiguities in accounting rules promote unreliable and noncomparable reporting.

4. As discussed in our report, we believe that the Interagency Policy Statement discourages inferring discount rates or market values from depressed markets in developing such fair value estimates. Therefore, we

remain concerned that transaction prices will not be given full consideration in establishing fair values.

5. We concur that "fire sales" including such sales made through auctions should not be considered representative of market prices. Widely publicized auction sales, and sales of properties under conditions which expose the property to the marketplace for a period of time sufficient to allow all willing buyers to be aware of the property's availability, should be considered in determining whether market prices are representative. Auction sales by FDIC and the Resolution Trust Corporation (RTC) are not intended to be, and are not represented to the Congress as being fire sales. Bids are not generally accepted without regard to value. Accordingly, we believe such auction markets, which are currently active in many parts of the country, should be considered in the valuation process.

We believe that market transactions in depressed markets must be considered in the valuation process for nonperforming assets. Although the market for distressed real estate may not be as robust as trading markets in securities and other assets, it does provide an indication on the prices which have been required to affect transactions. In the case of listings, a ceiling is established which indicates prices at which other market participants are willing to sell properties.

6. We agree that standard variables, such as arbitrary time frames, are not appropriate, including the arbitrary time frames developed by OCC (and recently rescinded) as referenced in FDIC's response. We do believe that guidelines can and should be developed to assess judgments applied in determining lease up periods and the foreseeable future. Decisions not to use transaction data in deriving fair values for collateral dependent loans need to be documented to support such conclusions.

7. GAO recognizes that the process for developing an allowance for loan and lease losses (ALLL) is inherently judgmental. Some management discretion to develop assumptions and assess the probability of loss is unavoidable. However, reasonable benchmarks are needed to guide management in making these critical judgments and for use in assessing the reasonableness of such judgments.

8. GAO agrees that discipline is imposed on the reserving process through the functioning of auditors and supervisory agencies. The recently enacted requirements for annual on-site examinations will aid in ensuring that the necessary discipline is imposed. However, the effectiveness of the auditor

and supervisory agency imposed discipline is constrained by ambiguities and inappropriate criteria in the key determinants in the loss reserving process. Supervisory agencies can arguably impose their will and narrow the range of acceptable judgments on a case-by-case basis in each examination, in effect substituting examiner judgments for judgments the examiner decides are inappropriate. However, this approach has considerable weaknesses. Additional guidance would aid in ensuring that more uniform and appropriate judgments are made.

9. GAO does not advocate the use of liquidation values for nonperforming assets. However, GAO does not believe that the strategy of many institutions was to make loans which would default to the degree that occurred in the last several years. The role of banks as financial intermediaries is distinct from their current unfortunate role in many cases as the manager of distressed loans and underlying collateral. For such nonperforming assets, GAO believes that market indicators exist and are relevant in the loan loss reserving process. The fact that many sales in a particular market occur at depressed prices, even if such sales are auction sales, provides a relevant indication of what an institution can currently realize from the distressed asset, and provides insights into the discount rates investors are requiring to purchase such assets. Even the auction sales of the Resolution Trust Corporation provide a relevant indication of market values. It is unclear to us why a buyer of properties in such depressed markets, and an existing holder of similar assets which are nonperforming, should value these assets at markedly different values.

10. We agree that it may be appropriate to conclude that a market may develop more stability with the passage of time. We do not believe that it is appropriate to assume that a market which has declined will reverse course in the near future, and we also do not advocate assuming that markets which have declined will decline further. See appendix I for specific passages from the Interagency Policy Statement that suggest a return to "normal" conditions can be anticipated. The Interagency Policy Statement discourages inferring discount rates from the existing market in depressed markets. This suggests that the stability being sought is not just the lack of wide swings in prices, but the advent of higher prices. To the extent that this was not the intention of the regulatory agencies, we believe that the Interagency Policy Statement should be withdrawn and revised. We concur that it is appropriate to reflect lease up of properties to a rate supported by the existing pool of tenants in an area, taking into consideration the pool of properties competing for those tenants. For buildings which are fully leased, the corollary would be to determine whether loss of tenants to new

properties will decrease occupancy over time. The regulatory agencies are uniquely positioned to compare and contrast appraisal assumptions for the significant properties in an area and ensure that the assumptions in such appraisals are supported by the areas' pool of tenants.

11. Further deterioration in markets after failure of the institution, the focus of FDIC and RTC on selling assets before they deteriorate further, and efforts to avoid considerable costs to hold and manage distressed assets, have clearly contributed to losses. Our review of existing GAAP also indicated that the previously unrecognized losses were due, at least in part, to ambiguities in accounting rules for loan losses and the lack of a fair value focus based upon existing market conditions.

12. OCC questioned whether the differences between FDIC estimates of the values of the assets of failed institutions and their historical cost carrying amounts as adjusted by recorded loan loss reserves supported our recommendations that accounting rules be changed. In our report, we acknowledge that internal control weaknesses, questionable judgments made by management and concurred in by their auditors, and the disruptive process and liquidation focus inherent in resolving failed banks are partially responsible for the different loss estimates.

In our Failed Banks report, we illustrated the disparities in estimating required loan loss reserves which can exist between management and FDIC examiners upon failure of the institution.

One such example, excerpted from pages 23 through 25 of the Failed Banks report, identified recorded loss reserves of $844 million for the loan portfolio compared to $3.9 billion estimated by FDIC. The disparity in loss reserves was attributed by FDIC personnel to problems with borrower financial stability, collateral values, and projected cash flows not fully recognized in the bank's reserving process which were recognized by FDIC in developing their estimates of the ultimate value to FDIC of the bank's assets.

While it is true that the information used in our analysis was prepared as estimates by FDIC, our audit work for the federal depository insurance funds and the Resolution Trust Corporation indicates that for large numbers of institutions such estimates are reasonable, and that, in any case, it can hardly be disputed that the insurance funds incur losses in disposing of failed institution assets. We believe that the rules used to recognize and measure loan losses and the ambiguities highlighted in such

rules in our report were a major factor in not reporting a portion of these losses on the balance sheets.

13. It is important to emphasize that the improvements in accounting rules for loan losses we suggest are intended to provide more reliable information for use in the supervisory process and by investors. Mere development of this information is not intended to cause actions to close banks if such actions are not appropriate from the standpoint of the regulators' responsibilities to foster a sound banking system and protect depositors and taxpayers from loss.

14. Our inferences as to the regulatory agencies use of discounted cash flows are reasonable interpretations drawn from the passages in the regulators own Interagency Policy Statement. As discussed in comment 10, we believe the Interagency Policy Statement should be withdrawn and revised. The loan loss reserving process we envision would require that the first reference in developing fair value estimates be to market prices. Existing requirements in GAAP give preference to observable market transactions in developing fair values. We believe that the reasons for not using such prices must be carefully weighed and documented.

15. We believe that when loans become nonperforming and are considered impaired, a new measurement of the value of the loan is appropriate. Remeasurement and use of a new carrying basis for impaired loans is consistent with the historical cost accounting model. Remeasurement is currently required for foreclosed assets and in substance foreclosed assets.

16. Our review of the referenced guidance and discussions with OCC staff indicated that existing OCC initiatives are not currently responsive to our concerns. See also, comment 8.

17. We have modified our report to note that general reserves for losses inherent in performing loans were not encompassed in our review.

18. OCC regulations (12 C.F.R. 34.43) require that appraisals be performed for certain types of real estate-related transactions. The regulations (12 C.F.R. 34.44) also require that such appraisals meet certain requirements, including uniform appraisal standards. However, for a transaction such as a real estate loan which subsequently becomes troubled, the OCC's March 20, 1992, revision to Examination Circular 234 eliminates the requirement that banks annually update the appraisal. OCC did not provide documentation supporting its assertion that bank

management is required to update appraisals consistent with the intent of the uniform standards as part of the bad debt reserving process.

19. It is our view that nonperforming loans should be measured using fair values. To the extent that nonperforming loans are collateralized loans, the fair value of the collateral provides useful information in assessing the fair value of a loan. However, to the extent that other borrower funding is available, a loss need not necessarily be recognized for collateral shortfalls. This is because the existence of other borrower funding and mitigating factors indicate that the fair value of the loan may be higher than the fair value of the underlying collateral. We do not advocate the use of market values for underlying collateral as the sole determinant of fair value for nonperforming loans with alternative payment sources.

20. OCC was unable to provide documentation to support its assertions regarding industry practices.

21. Examination Circular 234 (Rev), which formally implemented the November 1991 Interagency Policy Statement and revoked EC-234 Supplement 1, was issued after the date of initial circulation of our report for comment. Our final report has been revised accordingly. See appendix I.

22. We agree that capital is becoming increasingly important in the existing regulatory system and in the evolving internationalization of capital requirements. Such requirements make it that much more important for reserves to reflect economic reality in the evaluation of nonperforming loans. We have advocated only the reflection of economic concepts, and not a liquidation focus, in valuing nonperforming loans.

23. Classification methods can be a useful tool in developing loan loss reserves. However, identifying that some assets have a significant enough risk of loss to warrant classification, and then applying an ambiguous threshold in determining whether such losses should be recognized, illustrates the bias which can be interjected into the loan loss reserving process by the "probable" criteria.

24. We concur with this assessment, which is consistent with the recommendations and analysis in our report.